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Forming Real Estate Syndicates

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Editorial Staff
Legal Editor/Publisher:
Fred Crane

Project Editor:
Giang Hoang-Burdette

Contributing Editors:
Nick Love
Bradley Markano
Anthony Renaud
Connor P. Wallmark

Comments or suggestions to:
first tuesday, P.O. Box 20069, Riverside, CA 92516
www.firsttuesday.us

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Introduction

Forming Real Estate Syndicates is part of the **first tuesday** series of California-specific real estate study materials. Each title in the series of advanced study has a different topic as its primary content. As part of a comprehensive real estate education program, the series includes Real Estate Matters; Landlords, Tenants and Property Management; Tax Benefits of Ownership; The §1031 Reinvestment Plan; Creating Carryback Financing; Buying Homes in Foreclosure; and Due Diligence and Disclosures.

first tuesday's real estate series uses plain language and eliminates the extensive overlap of identical course material commonly offered by other publishers.

Forming Real Estate Syndicates is written for real estate licensees, attorneys and investors. This course material is designed to be an educational tool for use in the classroom and as a technical research and reference tool on group investments in California.

The objective of this material is to fully provide the real estate professional, acting as a syndicator, with the knowledge needed to use the limited liability company (LLC) entity in group investment programs. **Forming Real Estate Syndicates** also discusses syndication activities and their chronology, the laws governing LLCs, the use of investment circulars to solicit investors, and LLC operating agreements for management of the investment group. Also analyzed in this material are investment activities that present a risk of loss controlled by securities law and tenant-in-common co-ownerships.

Included, with an explanation for their use, are all the forms and notices required when bringing investors together for real estate syndication. Forms are treated as itemized checklists of disclosures by an agent and reviewed with buyers and sellers of real estate.

These forms fully reflect relevant codes, judicial decisions and practices in effect on the date of this publication. The forms referenced are developed and published by **first tuesday**. Unless a form cited in the book says, "See Form 150 *accompanying this chapter"* [emphasis added], it is not in the book. However, you can view the form on the Forms-on-CD, which contains the book, or online on the **first tuesday** Forms Download page.

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Chapter 1 — A chronology for syndication

This chapter sets out a chronological list of the steps taken to select and acquire property for a group investment program to be formed and operated as a limited liability company (LLC).

Guidelines for forming a group

A real estate broker who gathers investors into a group for the purpose of jointly buying, operating and ultimately selling an income-producing property is involved in a process known as *syndication* or *syndicate brokerage*. The broker who arranges the acquisition of property and organizes the group is known as a *syndicator* or *manager*.

Unlike sophisticated real estate investors who tend to operate alone, individuals who join together in syndication programs are generally uninformed and inexperienced about:

- the legal aspects and accounting of co-ownership;
- the economic factors that influence the movement of real estate rents and values;
- the responsibilities of property management; and
- the compensation a syndicator or manager is entitled to receive.

However, the broker acting as a syndicator undertakes the agency duty of fully informing each individual prospective investor of all aspects of the property and the investment program that might influence a prudent investor's decision to contribute funds.

A chronological list of activities the syndicator should review and consider adopting when forming a limited liability company (LLC) for the acquisition and ownership of an income-producing property includes:

1. Researching available residential or nonresidential rental properties and selecting one to be investigated and confirmed as suitable to purchase. (Non-income-producing property acquired by an LLC will require modification of the documents in this material.) [See **first tuesday** Form 185 or 279]

2. Analyzing the property selected, including its physical condition, the economic risks, environmental and natural hazards of the property's location, personal security, title conditions and property operating data. [See **first tuesday** Forms 304, 314, 321, 324, and 352]

3. Contracting to purchase the property in the name of the syndicator under a purchase agreement, an option to purchase or escrow instructions with a vesting provision allowing the syndicator to assign his right to purchase the selected property to the LLC. [See **first tuesday** Forms 161, 161-1, 401, and 159 §§10.6 and 13.3]

4. Opening escrow in the name of the syndicator, not the LLC, as the buyer. Prior to closing and after the LLC has been formed, the syndicator will assign his right to buy the property to the LLC. [See **first tuesday** Form 401]

5. Completing a due diligence analysis and confirming the seller's disclosures regarding the condition of the property's improvements, operations, location and title.
6. Applying for new financing or an assumption of the existing financing as called for in the purchase agreement.
7. Reviewing plans for the formation and management of an LLC entity with competent legal and accounting advisors.
8. Preparing the investment circular, subscription agreement, LLC-1 (Articles of Organization) and LLC operating agreement, along with their exhibits and addenda, naming the syndicator as manager of the LLC. [See **first tuesday** Forms 371, 371-1, 372, and 372-1]
9. Delivering copies of the investment circular to prospective investors to solicit them to become members and fund the LLC so escrow can close and the property be acquired.
10. Obtaining the signature of each investor on a separate subscription agreement and the signature page of the LLC operating agreement, and delivering their funds to the syndicator or escrow. [See **first tuesday** Form 373]
11. Entering into a property management agreement to employ the syndicator to manage the day-to-day operations of the property. This agreement must be signed by each investor who became a member of the LLC. [See **first tuesday** Form 590]
12. Arranging mortgage financing and signing loan documents for an assumption of an existing loan(s) or the origination of a purchase-assist loan, either in the name of the syndicator or on behalf of the LLC, as demanded by the lender.
13. Filing the LLC-1 (Articles of Organization), prepared and signed by the syndicator, with the California Secretary of State.
14. Assigning the syndicator's right to purchase the property to the LLC in an amendment to the escrow instructions, vesting title to the property in the name of the LLC on closing. [See **first tuesday** Form 370 or 401-2]
15. Funding the purchase price and closing costs from cash contributions received from the members of the LLC and mortgage financing.
16. Closing escrow and taking possession of the property.
17. Sending copies of all closing documents to each member.
18. Filing an LLC-12 with the Secretary of State within 90 days after filing the LLC-1 and biennially thereafter, and identifying the name and address of the manager as the agent for service.
19. Operating the property on behalf of the LLC during the LLC's ownership of the property and distributing earnings to the members.
20. Reselling the property when ownership of the property no longer meets the objectives of the investment group or when the initial goal was to sell or exchange the property after a period of time. The manager will negotiate the sale and the net proceeds will be distributed to the members on closing.

Chapter 2 Selection and acquisition of property

This chapter outlines the contractual provisions involved in an agreement to purchase real estate for syndication.

The benefits of group investments

For syndication purposes, real estate can be broken down into five basic categories:

- existing residential and nonresidential income-producing properties, called *rental property*;
- yet-to-be-built *construction* and subdivision projects;
- *pre-builder land*;
- *agricultural* land; and
- remote, generally *unusable land*.

This discussion presumes a limited liability company (LLC) will be formed to acquire an existing income-producing property, the category of property most prudent for real estate investment groups to own.

The benefits derived from the co-ownership of *existing rental property* include:

- an initial capital investment without the expectation of future additional contributions;
- minimal involvement by the investor;
- spendable income distributed periodically;
- equity buildup due to amortization of the loan amount through monthly payments paid from rental income;
- an increase in value resulting from monetary inflation and asset appreciation; and
- tax benefits provided by depreciation deductions and reinvestment on a sale of the property.

The other four categories of real estate investment properties do not offer all of these advantages.

Group investments in **construction projects** and **agricultural** or **business opportunities** contain additional inherent risks of loss classified as *corporate securities risks*. These "quasi-real estate" investment programs require the expertise of the manager in an ongoing business-related service or trade. The manager, or others, promise to **create value** for the co-owners after acquisition of the property through development, improvements or husbandry and sale of crops before a return on or of the investment can be expected.

However, the co-ownership and operation of **existing rental properties** does not contain corporate securities risks. The investors in a rental property receive an ownership interest in land and existing improvements. The asset they acquired as a group provides them with *full present value* for their contributions at the time of closing — the moment their funds are first placed at risk of loss.

Further, rental property acquired with a downpayment sufficient in size to give rise to spendable income can be held without the foreseeable need of additional capital contributions. The risk that co-investors might default on periodic advances needed to maintain ownership is eliminated by buying a "net cash flow" property.

Yet-to-be-built construction projects expose the investors' contributions to all the risks inherent in a real estate development. The need to complete the value-creating activity of construction to achieve success is a risk of loss controlled by securities law, not the workings of the marketplace.

An infinite number of persons and factors — contractors, subcontractors, laborers, material suppliers, architects, construction lenders, government agencies, insurance, costs, etc. — must be coordinated to **complete the improvements** before the investment program can enter the market, much less succeed.

On the other hand, **remote, unusable land** is not as flexible as an investment as other types of property. However, the co-ownership of land to hold for resale does not create a securities risk. Unusable land is purchased merely to be held for profit on resale. Remote, fallow land is unlikely to see its value increased by surrounding development or economic activity any time in the near future.

Also, remote land can be difficult to own. Since the land lacks any use and generates no income, investment groups tend to grow tired of the constant contributions for insurance premiums, taxes and loan payments required of owners of unusable property.

Undeveloped land located near existing development is more likely than remote land to be successful as a group investment. However, the syndicator must correctly anticipate that the land will appreciate in value due to local economic conditions and surrounding development.

The members of an LLC invested in undeveloped land must be willing to make periodic contributions of additional funds to carry ownership of the property since undeveloped land generates no income. If the LLC is formed to purchase undeveloped land, the operating agreement will need to include a provision requiring members to make additional cash contributions based on assessments set by the manager.

Escrow period

After entering into a purchase agreement to acquire property for syndication, the time period for closing escrow should be 120 days or more. A typical 120-day **timetable of events**, following the syndicator's entry into a letter of intent or purchase agreement to acquire an existing income-producing property, is comprised of the following periods of activity:

1. First 30 days: The completion of a due diligence investigation of the property and clearance of contingencies regarding the property.

2. Next 15 days: The completion of the investment circular with its exhibits, articles of organization (LLC-1) and LLC operating agreement.

3. Next 45 days: The solicitation of investors and full subscription of membership in the LLC.

4. Remaining 30 days: Extra time, if needed, to fund and close escrow.

SUPPLEMENTAL ASSIGNMENT INSTRUCTIONS

Assignment of Purchase Rights to LLC

DATE:_____________, 20______, at ____, California.

To ____

____

____

Escrow Number _________________________________

Date _______________________________, 20______

1. You are hereby authorized and instructed to:

1.1 Prepare a grant deed showing vesting in ____, a California Limited Liability Company; and

1.2 Receive third party deposits for the account of the limited liability company.

2. Buyer hereby assigns to this limited liability company all his interest in your escrow including any funds deposited by Buyer.

3. The limited liability company hereby assumes and agrees to meet all the obligations of Buyer in your escrow.

4. Seller hereby releases original Buyer(s) from all obligations under the escrow instructions and any underlying purchase contracts, and accepts the limited liability company as the substitute Buyer in these escrow instructions.

_______________________________________ (Seller)

_______________________________________ (Buyer)

_______________________________________ (Seller)

_______________________________________ (Assignee, LLC)

By _______________________________________ (Manager)

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If the LLC is not fully subscribed within 45 days after the investment circular is first presented to investors, it thereafter becomes increasingly unlikely that the LLC will ever be fully subscribed. Without investors, the syndicator will not be able to close the purchase escrow.

Taxwise, escrow should be opened in the name of the syndicator for the same reason the syndicator makes the offer to purchase in his name: to further establish his ownership of **property rights** created by entering into an agreement to purchase real estate in his name. Before closing, the syndicator will file an LLC-1 with the California Secretary of State and assign his purchase rights, tax-free, to the newly formed LLC. [Internal Revenue Code §721]

To accomplish the assignment and funding, the syndicator should consider opening two separate escrows. The first escrow is the *purchase escrow*, in which the syndicator as an individual is initially named as the buyer. During the **purchase escrow** period, the syndicator's right to purchase the property is as-

signed to the LLC in exchange for a Class B membership interest with a percentage of co-ownership in the LLC. [See Form 370 accompanying this chapter]

Thus, the purchase escrow is opened by the syndicator (as an individual) and closed by the LLC. Title to the real estate will be vested in the LLC.

However, neither the LLC nor the members should deposit funds in the purchase escrow until it is actually ready to close. The **deposit of funds** is the function of a second escrow, known as a *funding escrow*. The sole purpose of the **funding escrow** is to keep the funds contributed by the LLC members separate from the purchase escrow until the purchase escrow can be closed.

At closing, escrow is instructed to transfer the funds deposited in the funding escrow to the purchase escrow. The transfer will be made when the purchase escrow can close and vest title to the property in the LLC.

The purpose of the two escrows is to allow for the unrestricted return of the investors' contributions in the event any complications interfere with the closing of the purchase escrow. The funds deposited in the funding escrow are at liberty to be returned to the investor without the consent of the seller in the purchase escrow.

Alternatively, investors can deposit funds directly into the purchase escrow for the benefit of the LLC if the escrow used will provide for a *unilateral return* of those funds to the investors. Escrow may receive funds directly from each investor under a "receipt of third-party deposit" arrangement, stating the conditions for use or return of the funds. The investors are third parties, the seller and the LLC (by assignment from the syndicator) being the contracting principals.

Another arrangement the syndicator can provide to hold the investors' funds is an interest-bearing bank account in the name of the LLC. The account will hold the investors' funds from the time they are received until they need to be transferred to the purchase escrow at closing.

Controlling the property

Consider a syndicator who locates an income-producing property that appears suitable for an LLC investment program. It is available on advantageous terms if the due diligence investigation is successful.

Initially, the syndicator will not enter into a purchase agreement that commits him to the unconditional purchase of the property. Only after he has been able to fully investigate and be satisfied with the condition of the improvements and operations of the property, called a *due diligence review*, will he be willing to unconditionally commit to the purchase of the property. For permission to conduct a due diligence review, syndicators often use a Letter of Intent arrangement, but it provides no contractual control over the property should the syndicator later decide to buy it. [See **first tuesday** Form 185]

Further, the syndicator needs time to prepare an investment circular (IC). The IC will be distributed to investors to solicit their subscription and contribution to the purchase and joint ownership of the property.

To control a property without unconditionally committing himself to its purchase (and avoid use of a Letter of Intent), the syndicator has a variety of contract situations to choose from, including:

- a purchase agreement with contingencies;
- an option to purchase the property; or

BUYER'S SYNDICATION ADDENDUM

Equity Financing Contingency

DATE: _____________, 20______, at ____, California.

Items left blank or unchecked are not applicable.

FACTS:

1. This is an addendum to the following agreement:

☐ Purchase Agreement ☐ Counteroffer

☐ Escrow Instructions ☐ ________________________________

1.1 ☐ of same date, or dated _____________, 20______, at ______________________________, California,

1.2 entered into by ____, as the Buyer, and

1.3 ____, as the Seller,

1.4 regarding real estate referred to as ____

____.

AGREEMENT:

In addition to the terms of the above referenced agreement, Buyer and Seller agree to the following:

2. Close of escrow is conditioned on Buyer funding the down payment on the price from contributions made by investors Buyer solicits who subscribe to membership interests in a limited liability company (LLC) (or co-ownership interests as tenants in common) which will close escrow as the assignee of Buyer.

2.1 On acceptance of this offer, Buyer to promptly undertake his due diligence investigation and complete his analysis of the property in a timely manner.

2.2 Buyer to promptly prepare an investment circular on satisfaction of his due diligence investigation at which time Buyer will solicit investors to contribute to the LLC (or as tenants in common).

3. Buyer may terminate the above referenced agreement on or before closing should Buyer be unable to sell sufficient LLC membership interests (or tenant-in-common interests) to fund the close of escrow on this transaction. [See **ft** Form 183]

4. ____

____

____

____

I agree to the terms stated above.

☐ See attached Signature Page Addendum. [**ft** Form 251]

Date: _____________, 20______

Buyer: ____

Signature: _____________________________________

Buyer: ____

Signature: _____________________________________

I agree to the terms stated above.

☐ See attached Signature Page Addendum. [**ft** Form 251]

Date: _____________, 20______

Seller: ____

Signature: _____________________________________

Seller: ____

Signature: _____________________________________

FORM 376 05-08

- escrow instructions with contingencies, without first entering into an underlying purchase agreement or option to purchase.

A *contingency* is a provision in a purchase agreement identifying a **condition** that must be satisfied or waived by the syndicator for the agreement to become enforceable by the seller. If the condition is not *satisfied*, the syndicator may cancel the agreement and avoid any obligation to purchase the property.

Contingency provisions requiring the syndicator's approval (or cancellation of the purchase agreement) should include, among other items, a review of the condition of the property improvements, leasing income and operating expenses, financing, title, the property's location and natural hazards surrounding the property. [See **first tuesday** Forms 279 and 159 §11]

The syndicator should also consider including a contingency provision in the purchase agreement or escrow instructions allowing him to cancel and avoid closing escrow if he is unable to fully subscribe an LLC investment program to fund the acquisition of the property. [See Form 376 accompanying this chapter]

Escrow instructions entered into in lieu of first entering into an option or purchase agreement must include contingency provisions necessary to protect the syndicator. When a written purchase agreement does not exist and written escrow instructions are the only documents entered into by the syndicator and the seller, the escrow instructions take the place of a purchase agreement or option as the contract binding the syndicator and seller. [**Tuso** v. **Green** (1924) 194 C 574]

Thus, when an underlying written purchase agreement does not exist, any contingencies in the escrow instructions have the same effect as contingencies in a purchase agreement. However, if a purchase agreement exists, the contingencies stated in it do not need to be restated in the escrow instructions unless they are of concern to the escrow officer's performance. Escrow instructions merely authorize a third party (escrow) to carry out the actions required of each party to close the transaction on the terms and conditions agreed to in the purchase agreement (and as amended in the escrow instructions).

As the initial buyer, the syndicator should also include in all purchase agreements he enters into a vesting provision which allows him to **assign his rights** under the purchase agreement to the LLC. The right to assign requires the seller's cooperation to deed the property directly into the LLC vesting. [See **first tuesday** Form 159 §§10.6 and 13.3]

Purchase options

Some sellers are uncomfortable with purchase agreements loaded with contingencies. The contingencies can interfere with the seller's ability to cancel the transaction should the syndicator be unable to close the purchase by the scheduled date and unwilling to enter into a mutual cancellation of the transaction.

Also, a seller might not want his property subjected to a binding purchase agreement that may ultimately be rendered unenforceable by the syndicator's use of contingency provisions to cancel the transaction.

An acceptable alternative for both the seller and buyer is for the seller to grant the syndicator an option to purchase the property. In an option agreement, the seller grants the syndicator an irrevocable right to purchase the property. To form a binding contract, the syndicator simply exercises his right to purchase within a fixed time period, called the *option period*. [See **first tuesday** Forms 161 and 161-1]

After the **option period** expires, the seller will be able to sell the property to another buyer, unaffected by the expired option. If the option is recorded, the option will not expire as a *cloud on title* until six months after either:

- the expiration date stated in the recorded option agreement or memorandum; or
- the date the option or memorandum of the option is recorded if the recording does not contain an expiration date. [Calif. Civil Code §884.010]

For the syndicator seeking to buy suitable property, an option to buy imposes no obligation on him to purchase the property. Conversely, the seller *is* obligated to sell, but only if the syndicator decides to buy the property by **exercising the option** during the option period. The exercise of an option is an acceptance of the seller's irrevocable offer to sell contained in the option.

In exchange for the seller's grant of an irrevocable offer to sell the property, the syndicator pays the seller consideration, called *option money*. The option has not been purchased and is not enforceable unless the seller receives some consideration, although the amount of the consideration may be as little as $100. [**Kowal** v. **Day** (1971) 20 CA3d 720]

Syndicators typically buy options with short option periods — three to six months — long enough to satisfy their need to reserve the property. Time is needed for the syndicator to complete his investigation of the property and form an investment group to fund the purchase. The option money might be set at an amount that will compensate the seller for his inconvenience since the property will be "off the market" during the option period. [See **first tuesday** Form 161]

Often, an insignificant amount of option money is paid for a short, initial option period, sometimes called a "free-look" period, which takes place under most letters of intent. During this period the syndicator completes his due diligence investigation. The term of the typical free-look option is 30 to 60 days for an **option money** payment of as little as $100.

However, the syndicator will need more time after the free-look period if he decides to acquire the property. Here, the syndicator should consider negotiating an option with one or more extensions following the expiration of the initial option period. More option money as agreed is paid to extend the closing date to provide more time to close escrow. [See **first tuesday** Form 161-1]

Any number of additional option periods may be agreed to, each following the expiration of the prior period. The number of option periods depends only on the seller's willingness to agree to grant extensions for compensation and the syndicator's willingness (and ability) to put up more option money.

In exchange for granting an option, the seller not only receives the option money but is able to keep it after the option period expires, since no forfeiture is involved as is often attempted under purchase agreements. Also, he is assured the syndicator will no longer have the right to acquire the property if the option period expires and the option is not exercised, even if the option is recorded.

Liquidated damages, liability limitations

A purchase agreement without contingency provisions allowing for cancellation exposes a syndicator to liability for money losses incurred by the seller for the syndicator's unexcused failure to close the transaction.

Usually, the only monetary loss a seller of income property incurs on a syndicator's breach and failure to close the transaction is a decline in the resale value of the property below the purchase price at the time of the syndicator's breach.

Money lost by the seller is generally reflected as a reduction in net proceeds received on a prompt resale of the property below the amount he would have received from the syndicator's transaction had the syndicator not breached.

Two types of money-damage provisions in purchase agreements address the seller's losses on the syndicator's wrongful cancellation or unexcused failure to close:

Figure 1 *Excerpt from **first tuesday's** Form 159 — Purchase Agreement for Income Property other than One-to-Four Residential Units*

10.8 Should Buyer breach the agreement, Buyer's monetary liability to Seller is limited to ☐ $_______________, or ☐ the deposit receipted in Section 1.

- a *liquidated damages clause*, better described as a *forfeiture provision*; and
- a *liability limitation provision*.

A **liquidated damages clause** sets out a fixed sum of money the syndicator will pay the seller in the event the syndicator breaches the purchase agreement. The syndicator agrees to pay the amount whether or not the seller lost money due to the breach.

While initially presumed valid, liquidated damages clauses are unenforceable by sellers in real estate transactions beyond recovering money actually lost due to the breach. Liquidated damages constitute a forfeiture unless equal or greater money losses actually exist. However, without actual money losses, forfeitures are barred by law as an unjustified windfall to the seller since to enforce them would allow the seller to keep both his property and the deposit. [CC §3275]

To recover money damages on a wrongful cancellation or unexcused failure to close, the seller with a liquidated damages provision who is challenged by a buyer (the syndicator) must prove he sustained actual money losses (the amount he may recover) as a result of the syndicator's breach. A liquidated damages clause literally states in plain words that a seller may claim money without having to prove he sustained any losses. However, by law, the clause is unenforceable as written when contested by a buyer in a real estate transaction. What the seller may recover are his money losses, using the deposit as a source for recovery.

As an alternative to a liquidated damages clause, the syndicator and the seller may agree to limit the syndicator's liability in the event the syndicator breaches the agreement.

If agreed upon by both parties, the purchase agreement used will contain a **liability limitation provision** setting forth the maximum dollar amount of seller losses the syndicator is liable for. [See **first tuesday** Form 159 §10.8; see Figure 1]

With a **liability limitation provision**, the seller can recover his money losses incurred due to the syndicator's breach, limited to the agreed-to ceiling amount.

Thus, if the property's value drops below his purchase price by the time the syndicator wrongfully cancels or fails to close escrow, the ceiling on the syndicator's liability has already been set, no matter how far the property value declined by the time of his breach.

A purchaser's lien for the deposit's return

A syndicator generally makes a cash deposit, called a *good faith deposit*, with his offer to purchase a property. Occasionally, the deposit is in the form of a post-dated check or promissory note, payable into escrow at a future date, after due diligence contingencies are eliminated and the syndicator intends to close escrow.

If the syndicator deposits funds into escrow and later breaches the purchase agreement, he is entitled to recover the deposit, less money losses actually sustained by a seller due to the breach.

For example, a syndicator breaches a purchase agreement at a time when the property's value is still equal to or greater than the price agreed to by the syndicator in the purchase agreement. Thus, the seller has not lost money due to a decline in property value at the time of the breach. The seller is entitled to recover nothing unless the purchase agreement called for him to make an alteration of the property's occupancy resulting in a reduction of rents.

Since escrow is not going to close, the syndicator demands the return of his deposit. The seller refuses to authorize the release of the syndicator's funds, claiming the deposit is forfeited, as agreed, due to the syndicator's failure to close escrow.

Since forfeitures in real estate transactions are barred by law and the seller will not return the syndicator's funds, the syndicator is entitled to a purchaser's lien on the seller's property for the amount of the good-faith deposit. The purchaser's lien is enforced by filing a judicial foreclosure action and recording a lis pendens on the property. [CC §3050]

Chapter 3 — The economics of income property

This chapter presents an overview of the economic benefits a rental property provides for syndicate investors.

Advantage in high-value property

The greatest benefits a syndicator and his group of investors are able to receive from an investment come from the ownership and operation of multi-million dollar, income-producing properties. All other investment fundamentals being constant, higher-valued properties are generally more efficient and thus yield greater returns over longer periods of time than do lesser-valued properties.

Investing in a multi-million dollar property gives the syndicator and his group an economic advantage over most individual investors. A syndicator pools capital from several investors. Pooling leverages the investors into property more valuable than most individual investors can afford by themselves.

Also, the syndicator's compensation, typically based on the price of the property acquired and its flow of rental income, is far greater when his time and effort is spent on high-value properties.

However, less experienced syndicators should initially stick with low-value properties; these are less tricky to syndicate. Multi-million dollar properties are more difficult to investigate and manage. Errors due to lack of experience and knowledge are dramatically compounded on larger, more expensive properties. Thus, the money and effort required to correct an error are more costly.

Earnings from rental property

Residential or nonresidential rental properties generate annual returns for co-owners based on four financial aspects of ownership, listed here in order of economic importance:

- net spendable income;
- loan reduction;
- increased property value; and
- tax benefits. [See Chapter 12]

Net spendable income

The rents received from tenants make up a property's *gross operating income*. Operating expenses and loan payments are paid out of the **gross operating income**. If rental income is insufficient to cover expenses and loan payments, members are called upon by the manager to contribute additional funds, a property condition called *negative cash flow*.

Conversely, any income remaining after payment of operating expenses and loan installments is referred to as the property's *net spendable income*. When a property generates a **spendable income**, the property is said to have a **positive cash flow**. Spendable income is the primary source of cash for distributions to

investors, called *cash-on-cash income*. Spendable income acts as a cushion mitigating the risk of negative cash flow brought about by a drop in the property's net operating income (NOI). NOI is rents minus expenses.

Spendable income generated by the investment is a return to the investor and the syndicator, calculated and referred to as a percentage of capital contributions. It is roughly comparable to interest received on money-market accounts and dividends paid on common stock. Thus, returns vary from time to time due to inflationary pressures on the pricing of goods and services and the Federal Reserve's management of the money supply. Other influences on rental income do exist, such as local economic stability.

The expectation of receiving a flow of spendable income without having to be involved in the day-to-day management of a property is a major inducement motivating investors to participate as contributing members in a limited liability company (LLC) investment program.

Loan reduction

Due to the systematic amortization of the debt built into the loan's payment schedule, the dollar amount of the annual principal reduction on a trust deed loan is a return of invested capital. However, the amount of the loan reduction is commonly calculated for investors as a percentage yield on their cash investment, not a return of their borrowed capital.

This loan reduction is a significant but **secondary source of earnings** since it functions as an *equity buildup* adding to the property's net worth. However, **equity buildup** cannot be distributed to investors until the property is refinanced or sold.

The annual debt reduction is best viewed as a *return of capital.* The loan amount originally funded part of the total capital the co-owners invested in the property. Taxwise, the amount of the annual depreciation deduction represents the tax-free return of the total of all forms of invested capital, cash savings and purchase-assist loan funds.

Typically, the depreciation deduction more than "shelters" from taxation that portion of the rental income used to reduce mortgage debt through loan payments for approximately two thirds of the life of a 30-year loan.

The principal balance of a long-term real estate loan is systematically reduced by constant periodic loan payments, a process called *amortization*. The reduction in the loan amount increases the property's equity by an equal amount (a "build up" in equity) as long as the dollar value of the property remains at or above the original purchase price throughout the life of the loan.

Thus, a **recapitalization** of the investment occurs during each month of ownership when the amount of the loan principal is reduced by installments paid from rent (or additional contributions). While the property's value remains the same, the equity in the property increases by the amount of the monthly debt reduction, an ongoing restructuring of invested capital (debt paid versus cash withdrawn).

When monthly installments due on purchase-assist financing are paid from the rental income received from the tenants, investors do not need to make further capital contributions to cover loan payments.

On resale of the property, the equity built up by the amortized reduction of debt is cashed out, generating taxable profits (unrecaptured gain due to depreciation deductions) and a tax-free return of capital for any loan reduction greater than depreciation deductions (since taxes have already been paid on the capital).

Typically, the investment circular contains a yield schedule that charts the annual dollar amount of loan reduction over a ten-year ownership period. The annual equity buildup attributable to the loan reduction during each of the ten years is presented as an average annual **percentage return on** the investors' original cash contributions.

A property's net worth over time

The **equity** in a property represents the property's *net worth*. By extension, a property owner's net worth includes the equity in the property. Equity is not equivalent to profits and is unrelated to cost basis, which pertains to the tax aspects of ownership.

Equity in a property is calculated as the difference between the property's market value and the principal balance remaining on any financing or other monetary liens that encumber the property.

The **owner's equity** in a property is the result of:

- *cash invested* to purchase or improve the property, an amount that does not include cash contributed to cover any negative cash flow during the ownership of the property (unless used to reduce debt);
- *loan reduction* through amortized loan payments and any additional payments of principal, called *equity buildup*; and
- *increased market value* of the property due to inflation, appreciation or management, called *growth factors*.

An increase in property value

Real estate located in areas experiencing population and wage growth tends to increase in value over time. This increase is due to a combination of monetary *inflation*, local appreciation and efficient management of income and expenses, called *growth factors*. Meanwhile, proper maintenance keeps the physical aspects of the property unmarred by obsolescence and deterioration.

Inflation is a decline in the purchasing power of the dollar, measured by the federal government and reported through the consumer price index (CPI). Thus, over time, more dollars are required to purchase the same property in the same condition, called *monetary inflation*. Inflation is a reflection of changes to the dollar, not the property.

Inflation is reported as the percentage of periodic increase in the dollar price paid for goods and services — real estate — not in the logical alternative as a decrease in the quantity or quality of goods and services a dollar will buy. Over the years, the dollar value of properly maintained real estate tends to keep pace with inflation, so long as:

- the location of the property has a static or increasing population and employment base; and
- the per capita income (earnings) of potential tenants increases annually at a rate no less than the rate of inflation.

To reap the "benefits" of real estate as a *hedge against inflation*, the manager of a property does not need to do anything more than maintain the property by:

- repairing it to remove wear and tear; and

- replacing fixtures to eliminate physical obsolescence.

Periodically, property **increases in value** at an annual rate greater than the rate of inflation. The rate exceeding inflation is classified as *appreciation* since events beyond the devaluation of the dollar are driving the additional increase in value.

Appreciation in property values is the result of favorable local economic conditions, e.g., consumer demand for the location leading to an increase in the local population density — more people per square mile — or the wealth of the local population.

It is the goal of a syndicator to acquire a property that is in an appreciable location. Thus, it is likely to increase in value beyond the annual rate of inflation to deliver to investors a *real return*.

To garner this future increase in the property's market value at a rate greater than the rate of inflation, the syndicator selects property located where conditions within its immediate vicinity will likely bring about an increase in local population density (or per capita income). Thus, the property will experience an increase in both demand and the rents paid for residential and nonresidential rental space.

Finally, an even greater increase in property value beyond the effects of inflation or appreciation may be achieved by the syndicator's **management capabilities** to reduce operating costs and increase rental income.

Efficient management and attention to the amenities of a property tend to increase a property's NOI. As a result, the value of the property also tends to increase since capitalization rates for setting a property's value are applied to the property's NOI.

Chapter 4 — The reduction of investment risks

This chapter looks at the syndicator credentials that indicate the investment opportunity offered is more likely to succeed than fail.

First, be a capable syndicator

A broker must have credentials to engage in the activities of a syndicator. Credentials include the abilities to:

- select suitable property for the right *price*, on the right *terms*, at the right *time* and in the right *location*;
- enter into purchase agreements;
- conduct a due diligence investigation and analysis;
- arrange purchase-assist financing;
- determine the proper vesting for title;
- manage the landlord-tenant relationship;
- preserve the property's value by repair, maintenance and replacements; and
- account for income, expenses and mortgage payments.

Properly honed, the composite of these abilities represents an expertise sufficient to cope with the foreseeable challenges presented by the ownership of income-producing real estate. The broker possessing these qualities demonstrates he is qualified to manage a real estate investment program for himself or a group.

Without a background of education, training and experience in the acquisition, ownership and disposition of income property, a broker is not fully qualified to lead a group of unsophisticated investors into the co-ownership of income-producing real estate.

The investor's point of view

To analyze his *risk of loss* when investing capital, a prudent investor must begin by judging the capabilities and competence of the syndicator. Since success is dictated by property selection, financing and management, the greater the syndicator's credentials, experience and talents, the less the risk of failure.

To see an investment program through to fruition, the syndicator must have an evident sense of purpose, i.e., a consistency of behavior, determination and focus. Without a showing of his finely-honed competence for buying, owning and selling real estate over a long period of time, solicited investors will instinctively be put off by a syndicator's lack of experience. They will sense the existence of an increased risk of losing capital due to the syndicator's lack of drive, dedication and experience.

A syndicator must be able to present himself as a manager able to see his way through the difficult stages of an investment and emerge successful at the end of the process, in spite of local economic upheavals that will cyclically beset the property.

Experience selling income properties, either on behalf of an owner or when acting as a principal, is evidence the syndicator understands the challenge of selling property. Operating a property month after month, then selling it during the short window of maximum liquidity for a resale opportunity in a real estate business cycle is a difficult task.

In application, the **price paid** for a property becomes the initial indicator as to whether a profit will likely be realized on its resale. Further, the **terms for payment** of that price — the financing — must reflect the local economy's future stress on rental income and cash flow from the property, all of which affect the ability to retain ownership.

The **timing of a purchase** is best understood by a syndicator who has gone through at least one full real estate business cycle — from bust to boom and back. This provides a personal grasp of the difference between the concept of historical equilibrium trends in property values and the reality of price movement during a business cycle, with its excessive rise and fall in real estate prices.

Selecting the correct phase of a business cycle — preferably the end of the recessionary phase after a bust — as the time to select and buy property to assure a profit on its resale is an absolute necessity for getting an advantageous price.

However, few buyers are willing or able to acquire property at any price during recessionary lulls in the real estate resale market. Thus, the syndicator, by choice, is a "market maker" of sorts. He prudently goes into the market to buy at a time when few others are willing and able to compete. To do so, he creates a buyer in the form of himself and a limited liability company (LLC) full of cash investors who would otherwise be unlikely or unwilling to individually buy property in or at the end of a recession.

Thus, a syndicator promotes the acquisition of property in a market following the height of foreclosure and real estate owned (REO) action where few sales exist and when speculating buyers are sparse. In timing acquisitions for long-term investment, the syndicator must take advantage of the temporary (cyclical) dearth of buyers in the marketplace at the time sales volume begins to increase (based on fundamentals, not speculator activity) but before prices start to pick up. This is typically a 12-to-18 month window period and occurs long after the current cycle's recession has been declared as ended.

During a well-developed buyer's market of greatly reduced sales volume and the second off-loading of properties held by speculators, the syndicator is better able to negotiate a price and terms for its payment that will help insulate against the risk of a loss of invested capital.

By taking advantage of market prices that drop below the equilibrium trend, a built-in profit is realized the instant the period of ownership moves into the recovery phase of the business cycle. Prices then begin to rise in a trajectory pushed upward ever faster by the recovering demand and fueled by increasing numbers of "fair weather" investors and the ever-recurring flow of first-time speculators.

A local track record of achievements

The *personal achievements* of a syndicator also lend credence to his syndication efforts. Investors sense a greater probability of success in an investment selected and managed by an accomplished individual — one with power — when his credentials include:

- at least three years' experience as a property manager, operating his own income properties or properties on behalf of others;
- at least three years' experience as an appraiser or as a broker providing opinions on value;
- creditworthiness sufficient to qualify for loans himself without relying on a co-signer or guarantor;
- cash reserves for emergencies, separate from funds used for investment;
- accumulated wealth, preferably in the form of equities in real estate;
- community service, such as involvement in civic affairs — social and political;
- longevity as a resident in the community;
- higher education and studies in real estate and business;
- licensing in related trades, such as construction, appraisal, real estate, lending, etc.;
- personal accomplishments of merit; and
- existing income from sources other than up-front fees for the current syndication of property.

Risk avoidance for equity investors

The primary financial purpose for the syndication of a property by a broker is to raise funds from passive investors for the down payment on the purchase of property that the broker will co-own with the investors. Thus, as the syndicator, the broker's fractional ownership interest in the property is l00% financed by mortgage money from a lender and equity capital provided by investors.

The syndicator's claim on the property's income and profits for his fractional ownership interest is junior only to the mortgage financing encumbering the property (as are the investors' ownership interests) if the syndicator's percentage of ownership participation is not subordinated to the ownership interests held by the investors, called *parity participation*.

However, without *subordination* of the syndicator's co-ownership interest to those claims on income held by the investors, the dollar value of the investors' percentage of ownership on closing will be less than the down payment they have funded to acquire the property, a condition called *watered stock*.

Accordingly, the fractional ownership interests acquired by most syndicators are, as a matter of practice, subordinated and junior to both:

- the mortgage financing (the first claim on the property's value); and
- the equity financing provided by the cash investors (the second claim on the property's value).

The syndicator whose fractional ownership interest in an LLC is a Class B subordinated ownership interest (the third claim on value) has financed the acquisition of his ownership interest through *mortgage financing* (lender) and *equity financing* (passive investors). This arrangement constitutes "double leverage" and provides 100% financing of his ownership interest.

From the income aspect, the syndicator's ownership claims dissipate the **earning power** of the investors' cash contributions, whether or not his ownership interest is subordinated.

Apart from earnings, the investors' **risk of loss** of their investment is analyzed based on the distinction between parity or the subordination of his co-owners' interests.

For example, investors typically are asked to put up at least 100% of the cash (equity financing) needed to acquire the property. When doing so, they agree to the "watering down" of their share participation in any future increase in the property value. They agree to receive less than 100% of the property's future increase in value in exchange for distributions of spendable income and net proceeds of refinancing or a sale that has priority to the syndicator's claims.

Thus, the investors dilute the earning power of their cash by sharing future growth with a non-cash investor, the syndicator, but do not increase their risk of loss or create a moral hazard by doing so.

Further, due to the dilution of the investors' earning power, on a resale of the property the syndicator *receives the first profits* resulting from an increase in the property's value over the price originally paid to acquire the property. The amount of this initial distribution of profits to the syndicator is limited to the dollar value given to his Class B interest. When subordinated to investor claims on profits, distribution to the syndicator from sales proceeds is based solely on an increase in property value.

Depreciation and book value (adjusted cost basis) of the asset only plays a role in tax reporting, not the sharing of spendable income or net proceeds of refinance or resale.

Conversely, the priority return of the investors' cash contributions is distributed based on the price paid for the property, before considering any increase in the property's value. Also, any minimum annual yield owed to the cash investors, which may have accumulated unpaid due to deficient spendable income in the past, has priority over any disbursement of sales proceeds to the syndicator.

After the initial pay out of net sales proceeds to Class A and Class B members to return their capital contributions with an annual minimum rate of return, any remaining sales proceeds are typically shared by all members on a pro rata basis — share and share alike. Thus, a Class A member's participation in the remaining profits is again diluted by the ratio of sharing between Class A and Class B members.

While Class A members are assured a priority return of their cash and a minimum annual return, to avoid the moral risk created by parity sharing, the syndicator, through his Class B ownership, imposes a dilution of the participation by the Class A members in profits on the sale — the trade-off investors make to enjoy a flow of income and full return of their cash contributions before the syndicator participates as a co-owner.

Funding the purchase

Like mortgage financing, **equity financing** provided by cash investors is primarily meant to fund the purchase of property, not to compensate the syndicator for the time and effort he spends contracting to acquire the property. Thus, equity financing is not generally considered a primary or major source of funds to compensate the syndicator for his acquisition activities. He receives an ownership participation for these pre-syndication efforts.

If the syndicator is to **remain solvent**, he needs to be reimbursed for all of his out-of-pocket expenditures related to the purchase of the property. Further, he needs to receive a **reasonable fee** for the organizational time and effort spent performing syndication activities, such as preparing the investment circular, soliciting investors and forming the LLC.

Also, the syndicator's time and effort spent locating the property, entering into a purchase agreement, conducting the due diligence investigation, arranging for the assumption or origination of purchase-assist loans and opening and closing escrow relates to the acquisition of the property. These real estate-related transactional activities warrant the receipt of consideration (a percentage of ownership) separate from the fee paid to the syndicator for services rendered to form the LLC and organize the investors.

Analyzing the risk of loss

Basic market factors common to all real estate transactions pose risks of loss no matter who owns the property or whether it is a single family residence, income property or vacant land. Commonly acknowledged **risks of ownership**, understood by even the most ill-informed investor, include:

- the purchase price;
- the down payment;
- mortgage financing;
- costs of ownership;
- the property's location;
- occupancy and rent;
- the maintenance of the property; and
- recovery of cash on a resale.

To provide a "comfort zone" sufficient for prospective investors to look further into the attractiveness of a syndicator's investment program, the syndicator must adequately address each of these market-related risk factors. His analysis of these risks must neutralize the initial fear of loss common to most individuals who consider a major financial move.

These market risks are the latent economic concerns of any investor. If not addressed by the syndicator, the typical candidate for group investment is probably unable or unwilling to ask questions on his own about real estate. Thus, an investor's gut reaction toward the investment will remain apprehensive, most likely barring a commitment to contribute as a co-owner.

Justifying the price and down payment

The first marketplace question that comes to the mind of every investor is whether the **purchase price** to be paid for the property is a proper amount. The syndicator must justify the price as below-market if he is to entice investors to look further into the investment's profitability on a resale. An appraisal report prepared by a credentialed and licensed fee appraiser stating the property's value at a dollar amount greater than the price the syndicator has agreed to pay for the property is a huge advantage.

Logical explanations as to why a seller will accept a below-market price include:

- the lack of a brokerage fee (typically 6%) on the transaction;
- a price based on earlier sales at lesser prices; or
- a price reduction that was vigorously pursued by the syndicator through offers, counteroffers and inducements of a substantial down payment or cooperation in meeting the seller's tax exemption goals.

A direct comparison by the syndicator (or the appraiser) to a recent sale on similar terms of a closely comparable property located in the immediate vicinity of the syndicated property provides evidence of good value in the syndicated property.

Since nearly all of the cash funds contributed by investors are going towards the **down payment**, an investor's instinct to avoid being "ripped off" is satisfied. The remainder of the cash funds, after distributing a small cash amount to the syndicator for LLC organizational efforts and costs, are held as *reserve funds*. This way the investor reduces his innate concerns about creating a moral risk of a loss by a diversion to the syndicator of funds borrowed or contributed to the investment.

The investor, aware of the percentage of ownership the syndicator is receiving, does not want to also pay the syndicator cash to help him acquire that ownership interest when the syndicator's percentage of ownership already dilutes the earning power of the downpayment cash contributed by the investor.

Also, the greater the amount of the down payment as a percentage of the price, the less the risk of loss on the investment and the greater the amount of spendable income. Further, a mortgage lender originating a loan with a lower loan-to-value ratio offers better rates and payment schedules since the lender can reduce his risk premium in the interest rate.

Recovery of contribution on resale

After a syndicator confirms that the present worth of the property is equal to or greater than the investor's cash savings being transferred to the real estate investment (and the mortgage amount), the investor needs assurance that the funds will be recovered on a sale of the property. Thus, it must appear to the investor that **market trends** will support the original cash investment and likely result in an increase in its value over the long term.

Clearly, a syndicator can offer his *opinion of value*, his expectations about future market trends, movements in property values and the presence of future buyers willing to purchase the property, as long as he has a reasonable basis for his opinion.

Documentation showing the direction of sales volume and prices of comparable properties during the six-month period preceding the purchase will help demonstrate whether prices are rising, dropping or flat. Given the constant recurrence of business cycles and their effect on the volatility of real estate sales and prices, the syndicator can rationally demonstrate what he believes will occur regarding an increase or decrease in the future willingness of buyers to buy and the likelihood of a respective rise or fall in prices and rents.

It is necessary to remind investors that inherent in the nature of a successful real estate investment is **long-term ownership**. To cash out on a resale, they must await a peak in prices during a business cycle — hopefully accompanied by a handsome profit for having acquired the property at the right price.

The benefits of the **monetary inflation** inherent in the hedge of real estate ownership take time to develop, as do the additional profits from **property appreciation** brought about by growth in the local population and their wages. These national monetary policies (inflation) and local demographic trends (population) drive up rental income over the period of a business cycle. With rising rents, the value of the property increases by a corresponding percentage if the capitalization rate for setting property values remains the same and operating costs do not rise faster than the rate of inflation.

An investor's fear of loss is probably best alleviated if the price paid for the property is less than the fair market value by at least the amount of the brokerage fees avoided on the purchase. The logic is that the property, if resold today for its fair market value, was purchased at a price that would generate net sales proceeds sufficient to return all the investors' funds — after payment of a full brokerage fee.

Purchase-assist mortgage financing

When an investor is solicited by a syndicator to participate in a real estate investment, the investor automatically reflects on what he has come to believe is helpful or harmful in a mortgage. Thus, investors are fairly comfortable talking about interest rates on real estate loans (fixed or variable) and the merits of a future refinance. An investor's background experience with mortgages aids in persuading him to subscribe to an investment, as long as the syndicator explains why the rate of interest he has agreed to for purchase-assist financing is good for the investor's future ownership.

Investors need to be advised on aspects of the purchase-assist financing, including:

- why a loan was arranged with a particular lender; and
- what fees, charges and yield spread premium the syndicator was able to avoid by negotiating the loan directly with the lender at the par rate.

If the interest rate is above *par rates* at the time of origination, the spendable income will be less than it would have been had the loan rate been at par — a huge unnecessary shift in wealth to lenders and loan brokers.

When unnecessary loan fees, charges and yield spread premiums are paid to a mortgage loan broker to negotiate the loan in lieu of direct lender negotiations by the syndicator, the amounts of both the debt underlying the down payment and the cash disbursed to others outside the investment group are greater than they should be. Here, the earning power of the invested cash is diluted and the risk of loss is greater than it needs to be.

The mortgage financing arranged for the purchase is either a *fixed rate mortgage* (FRM) or an *adjustable rate mortgage* (ARM). Whichever it is, the rate must be no greater than the current rate charged by lenders in the national secondary mortgage market.

Property values (prices) are inextricably and conversely tied to interest rates on mortgages. As marketplace mortgage rates rise or fall, the market value of all real estate moves in the opposite direction. This effect is comparable to the movement of rates and pricing in the bond market, but with a delay due to the stickiness of seller pricing.

Further, the type of interest rate (depending on whether the financing arranged was a FRM or an ARM) selected to help finance the acquisition has an impact on:

- the future worth of a property;

- the amount of spendable income remaining after monthly loan payments; and

- the ability to retain ownership.

A participating investor should be informed that when rates for purchase-assist mortgages and assumed loans increase, the pace of sales slows and the price paid for property declines.

Fixed rate mortgages

As real estate prices trend downward due to a rise in fixed rates on purchase-assist loans, lenders and sellers duel in a trade-off for the dollars paid initially and monthly by the buyer to own the property. As interest rates rise, prospective investors acquiring income-producing property insist on an increased **rate of return** (cap rate) on their cash invested in the property, after payment of operating costs and interest on the mortgage. Cash becomes king.

Operating expenses are difficult for management to reduce and rents are unlikely to be substantially raised on acquisition of a property. Also, older investors will not likely invest in an income-producing property without an annual cash return (from spendable income). Thus, the investors' annual cash-on-cash return requirements are met from the *net operating income* (NOI) remaining after payments on the mortgage — spendable income.

When market interest rates increase for new fixed rate loans, a reduction takes place in the amount of mortgage money the property can carry, thus the amount a syndicator can borrow to finance its purchase is also reduced. Mortgage loan amounts are based on the NOI available from a property to service interest and principal payments. The resulting loan amount (lower as interest rates rise), plus the down payment, establishes the maximum price a prudent investor (syndicator) pays for a property, not the price prayed for by the seller as the listing price.

Thus over time, mortgage lenders charge higher rates to earn more money while the seller's property loses value in a compensating amount. The lost property value represents the present worth of the increase in the *real rate* of interest earned by the lender. Thus, a shift in wealth from the seller to the lender occurs during periods of rising rates — if the seller chooses to sell.

Prospective investors, on the other hand, will experience no short- term benefits from the reduced price and no harm from the increased interest rates they pay. The price paid is the equalizer for the buyer.

Consider the fact that investors cannot lower (and the seller cannot raise) the price paid to the seller for the property once the purchase escrow has closed. Further, the lender funding a fixed-rate loan cannot increase the principal balance or the rate of interest agreed to by the investors. However, the investors **can refinance** in the future and reduce the rate of interest on their mortgage financing, often dramatically.

On refinancing the original purchase-assist loan in future years at lower rates, the spendable income generated by the investment will increase. The increase will equal the difference between payments on the old loan and payments on the new loan. Thus, a windfall of additional spendable income occurs. Also, the value of the investment is strengthened since the risk of loss inherent in any future decrease in rent or increase in operating costs is reduced by advantageous refinancing.

Adjustable rate mortgages

Using an ARM loan to finance a syndicated property complicates the syndicator's disclosures when reviewing the adverse effects of ARM mortgage financing. The syndicator needs to demonstrate that the ARM loan was selected because the *note rate* on the ARM, while variable, will most likely decline in the future.

The ARM **note rate** is different from and always greater than the initial qualifying or teaser rate. Thus, by taking on an ARM loan the syndicator is gambling that the note rate will drift lower rather than higher. However, it is an unlikely economic scenario that allows rents to rise and cover increasing payment of ARM rates since short-term interest rates are rising at the same time.

An ARM loan is tied to an index of **short-term loan rates**, not long-term mortgage rates. High, short-term consumer rates are set by the U.S. central bank (the Federal Reserve) to fight inflation. In doing so, the bank causes ARM rates to rise and the domestic economy to slow, placing it in an informal recession — a business slow down. Conversely, a drop in short-term rates allows the economy to pick up (through more employment to increase production of goods and services), which in turn generates more real estate sales (and tenants).

As short-term rates drop, a decline in ARM rates follows, eventually reducing the dollar amount of monthly ARM payments and producing more spendable income (or reducing the negative cash flow). Also, sales volume increases to re-commence price increases, all triggered by lowering short-term rates to or below inflation rates.

When ARM financing is employed to fund the purchase of property, the ARM will eventually need to be refinanced, replaced with a lower fixed-rate loan for the duration of the group ownership. Any investor who grasps the math of the future buildup in a property's value and the increase in spendable income over years of ownership under a fixed-rate loan can handle the math of these loan arrangements.

Analysis of operating costs

Operating costs incurred during the ownership of a property are generally not of concern to the typical passive investor in syndication. No formulas, rules of thumb or guidance exist for syndicate investors to use to make a quick analysis of value — just look at pricing in the *real estate investment trust* (REIT) market. Further complicating an analysis of operating costs, each property is unique. Also, expenses for repair, maintenance and general care of a property vary hugely from property to property due to causes that are better understood by first preparing a structural engineer's report or completing a due diligence investigation of the property.

However, if operating costs are temporarily increased to cure **deferred maintenance** and **accumulated obsolescence** or amenities, these costs are suddenly a subject of great positive interest to investors. They are a benefit to investors. The end result is increased value due to the one-time event called *sweat equity*, and more spendable income due to a one-shot increase in rental income.

A temporary increase in costs to cure deferred maintenance on the property, increase or upgrade security for the tenants or add facilities and amenities to keep and attract a better class of tenants generates increased rents. In addition to reducing the investors' risk of loss, these activities tend to increase the NOI and thus the spendable income distributions they will receive. Without a change in capitalization rates, the property's value will increase by the same percentage as the increase in NOI, the *sweat equity*.

Occasionally, rents are below-market and can be raised without significant cost. A reasonable plan for executing any rent increases proposed in the investment circular needs to be prepared and presented to the investors.

A detailed plan is especially necessary if scheduled income is forecast based on rents that are anticipated to be greater than the rents tenants now pay. Some units will be on leases with rents that cannot be altered until expiration of the leases, thus interfering with the timing of the increases. Others are under rental agreements or expired leases that allow for increases after service of appropriate 30- or 60-day notices.

A timetable needs to be prepared on a spreadsheet and presented to the investors. It should list each unit, when and how much each tenant now pays in rent, and the rent amount he will be required to pay in the future.

Distributions based on priority returns

Consider a syndicator who, on entering into a purchase agreement and confirming the property's suitability, places a dollar value of $100,000 on the assignment of his purchase rights to the LLC.

The valuation of a syndicator's assignment often represents roughly 6% of the present fair market value of the property, a brokerage fee in any other sale of the property. If he were to sell his contract right to purchase the property to another buyer, that buyer should be willing to pay $100,000 for the syndicator's position, in addition to paying the price the seller has agreed to in the purchase agreement.

The price paid under the purchase agreement calls for a down payment of $250,000, approximately 17% of the purchase price. The syndicator intends to fund the down payment by raising $60,000 from each of five investors, a total of $300,000 in cash. The $50,000 in surplus cash will provide funds for a $10,000 fee to be paid to the syndicator as compensation for organizing the investment group and $40,000 to be held by the LLC as **cash reserves** and additional working capital.

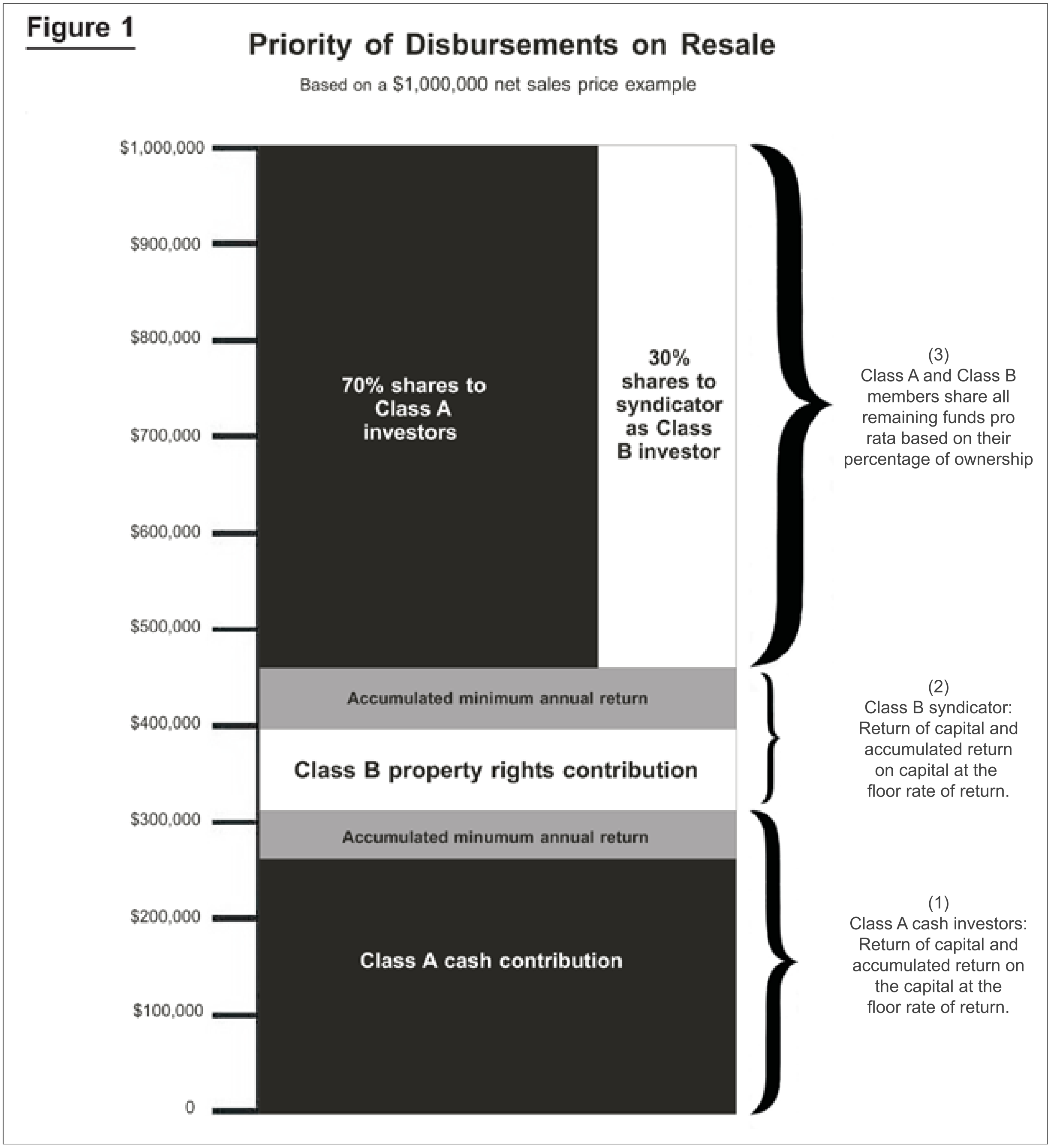
The syndicator will not be paid cash for assigning his contract rights under the purchase agreement to acquire the property. Instead, he will receive a $100,000 Class B interest in the LLC as a co-owner with the cash investors (Class A members).

Thus, the combined amount of all capital contributions ($400,000), comprising the cash raised from the investors ($300,000) and the value set for the assignment of the syndicator's purchase rights ($100,000), becomes 100% of the capital contributions. Each co-owner's percentage **share of earnings** from rents and sale of the property is initially set as the percentage their contribution represents the total dollar amount of all forms of contributions made by all co-owners, Class A and Class B.

Thus, the investors will collectively hold a 75% co-ownership interest in the LLC as Class A members for their $300,000 cash investment. The syndicator will hold a 25% co-ownership interest as a Class B member for his contribution of his right to buy the property.

However, cash investors do not typically consider the syndicator's contribution of his purchase rights as equivalent to their hard-earned (after-tax) cash contributions. Investors consider a syndicator's efforts as promotional, illiquid and untaxed since his interest has not been reduced to cash by a resale of the property.

Unless restrictions and limitations are imposed on the syndicator's share, all members will share earnings from spendable income and the proceeds of a sale (or refinance) equally, a *parity distribution* of funds.



Parity (equality) among all co-owners places the cash investors and the syndicator on equal footing. Thus, the investors' funds are in eminent danger of a partial loss if the property does not resell for a price exceeding 10% more than the price the group paid for the property.

When sharing spendable income and sale proceeds, priority for the claim of cash investors as **Class A members** over the syndicator's claims as a **Class B member** must be a condition of the sharing arrangements. If not, it is unlikely the syndicator will attract investors since they may doubt the likelihood their cash investment will be returned.

Front-end earnings for the syndicator's sake

Arguably, a syndicator's assignment of his contract right to purchase the property has a present cash value equal to the dollar amount of the membership interest he will receive in exchange. Typically, the valuation of the syndicator's ownership interest is either:

- equal to a cash commission a listing broker would have received on a sale of the property; or
- the difference between the reasonable fair market value of the property and the lesser price paid for the property.

In either case, why should the syndicator's percentage share ownership be on a subordinated basis to the cash investors, and not on a "share and share alike" arrangement for distributions of all earnings?

The answer lies in moral risk: instinctively, investors hold feelings that the syndicator's participation on a parity basis (or worse yet a full commission as their agent) leaves the syndicator with *significantly reduced* incentives to properly structure the acquisition and manage the property than had he not received cash up front. Instead, he should receive a fully subordinated share of earnings.

If the syndicator receives an ownership interest with a participation in earnings equal to the cash investors' earnings, he has less motivation to:

- make the best selection of property and acquire it on the most advantageous financial terms;
- pay constant attention to the management of the property and tenants; and
- pick the right time to sell the property at the maximum market value.

To **shift the risk of loss** posed by the potential failure of the syndicator's motivation, the syndicator's interest must be subordinated to eliminate the equal treatment of parity distributions. When subordinated, the syndicator first shoulders the *risk of loss* if the property does not live up to his cash flow expectations.

Also, the value he claims his Class B membership is worth will not be achieved on a resale if the property does not increase in value. When the syndicator acts to protect the value of his Class B interest in the investment, his own self-interest automatically provides protection for the financial interests of the investors in the property as well.

However, the investors' payment of a cash fee to the syndicator in a small amount on acquisition of the property is appropriate. It is fair to assume a syndicator who does not "sell the property" to the group he forms, but seeks investors to "join with him" to jointly own the property, has an operating overhead and personal expenses.

A real estate broker in the business of creating investment groups to acquire property in which he takes an ownership position will soon be out of **cash reserves** unless he generates cash income during his first three or four years syndicating properties. Services rendered in organizational efforts to form a group are separate from the efforts involved locating property, negotiating the purchase contract, and arranging to close escrow. Thus, the syndicator logically merits a cash fee for the organizational services rendered to the LLC and investors prior to closing.

Distribution during ownership

The payment of **management fees** to a syndicator for managing the leasing, ongoing care and maintenance of the property and rendering the services commonly expected by tenants is a diversion of a portion of the rental income to the syndicator. However, it is a necessary and proper one, comparable to the payment of other operating expenses. A third-party broker with expertise in property management would otherwise be employed to manage the operations of the property, and a fee would be paid.

In order for the syndicator who manages the property to legitimize the amount of his fee, he must show it is *fair and reasonable*. Justification is needed since he has literally hired himself to manage his property and will receive a fee for doing so.

Further, the payment of a management fee before a return is distributed to investors has economic justification. The cost of supplies, labor and management are paid from income (rents) as expenses of ownership before funds remain for disbursement to the co-owners as spendable income (a return of capital, dividends, etc.).

As further justification, the syndicator receiving a management fee does not receive any portion of the spendable income until the co-owners have first received a **minimum annual rate of return** on their invested capital. Only if distributable funds then remain can the syndicator share as a subordinated co-owner. [See Figure 1 accompanying this chapter]

Typically, the minimum rate for the investor's annual yield is *cumulative*. If spendable income is not available for disbursement in the full amount of the minimum annual rate of return on investment, the unpaid amount accumulates. The unpaid accumulation will receive priority disbursement in later years when funds from any source become available for distribution.

After spendable income has been disbursed at the minimum rate of return to both the priority (Class A) and subordinated (Class B) co-owners, any spendable income then remaining is distributed on a parity basis between all co-owners, Class A and B, without concern for priorities.

Occasionally, a **ceiling rate of return** is set for total annual participation in the spendable income by cash investors (Class A members). When a ceiling exists on earnings that limits their annual return from rents, the balance of spendable income is distributed to the syndicator under his Class B membership (not as a management fee).

The nature of the cash investors' Class A participation is similar to the ownership of cumulative preferred stock issued by a corporate entity. The investors receive an annual rate of return. Any remaining earnings go to the common stockholders, represented here by the syndicator's subordinated Class B ownership interest. Further, the syndicator's rights are often coupled with buy- out provisions containing options to acquire the member's interests or the property.

When the equity in a property is cashed out, in part or entirely, by a refinance or sale of the property, the net proceeds represent a *return of capital* to the co-owners. Funds from a refinance or sale are not operating income generated from rents. Again, any fees paid to a syndicator acting as a loan broker in arranging a refinance or further encumbrancing of the property, or negotiating the sale as a broker, is a proper diversion of proceeds that initially belong to all co-owners.

As always, a fee received by the syndicator must be justified as both necessary and reasonable in amount. Here, the nature of the brokerage services provided must be shown as necessary to the operation of the property, and the amount of the fee must be shown as competitive and comparable to fees charged by brokers who provide the same service in the local market.

The net proceeds from a refinance or a sale, being a *return of capital*, are first disbursed to the cash investors as a priority. The cash investors receive an amount equal to their original cash investment, plus a minimum annual rate of return, less any amounts previously disbursed to them from any source, such as spendable income or the net proceeds of a prior refinance or sale of a portion of the property.

Any proceeds then remaining from the financing or sale of the property after the priority distributions to the cash investors are next disbursed to the syndicator. He receives:

- the dollar amount set as the value of his Class B co-ownership interest that he received in exchange for the assignment of his purchase rights; plus
- his minimum annual rate of return; **less**
- any amounts disbursed to him as a co-owner (not for service as a manager) from spendable income and net proceeds of a prior refinance or sale of a portion of the property.

After all priority and subordinated co-owners have received a return of their original investment and the minimum annual floor rate of return on that investment, the remaining net proceeds are distributed to all co-owners on a parity basis, usually based on their percentage of ownership.

However, members may agree to a different ratio for sharing the remaining funds between Class A and Class B members, for example, 50% to Class A members and 50% to Class B members.

Occasionally, the parity claims of the investors are limited to their original investment and a maximum annual rate of return from all sources. Thus, the syndicator receives all sales proceeds remaining in excess of this maximum-ceiling annual rate of return for the cash investors.

Chapter 5 The syndicator's professional services

This chapter presents a syndicator's use of his real estate broker's license to render professional services as a syndicator and manager of real estate.

Licensing as a legitimizing force

Consider an individual, licensed as a broker, who has been earning a decent living from the fees he earns for handling the sale of income-producing properties and the purchase of developable land for builders. However, his net wealth is minimal, consisting of his home, two cars and a duplex. He acquired all these assets with little or no down payment and they are all encumbered with manageable debt. His credit is excellent, he maintains a minimal amount of consumer debt, has modest cash reserves and files income tax returns.

The broker is concerned about building his future net worth. He wants to attain a better quality of living and a higher civic status for himself and his family. To accomplish these personal objectives, the broker decides he needs to supplement the fees he is presently earning. He believes he can do so by acquiring the ownership of income-producing properties.

Being constantly exposed to income properties that come onto the market for sale, he begins to analyze the probabilities for his owning and operating a few of these properties. To achieve this goal he will need to co-own any acquisition with investors who will put up all the cash needed to acquire them.

The broker's efforts locating, contracting for and fully investigating the acquisition of property is a task at which he is experienced. Rather than a brokerage fee for packaging the property for an investor, he will take an *ownership interest* with one or more investors. The investors will invest enough funds to cover all his expenses related to the acquisition. Also, as an economic necessity, they will contribute enough funds to pay a modest front-end fee for his efforts spent soliciting the investors and forming a limited liability company (LLC) to own the property. He will be the manager — chief operating officer (CEO) — of the LLC.

On acquiring a property in an LLC, the broker will then become the *property manager*. As the manager, he will oversee any on-site resident managers, coordinate locating tenants and negotiate leasing arrangements and arrange for the care and maintenance required to protect and improve the value of the property. For these services, he will receive the same competitive management fees any other competent property manager would receive.

The amount of the management fee will be based on a percentage of the *gross rental income* produced by the property. Thus, the broker has incentive to attain the highest possible rents for the property. The greater the amount of rents, the greater the amount of his management fees, and in turn, the more valuable the property.

As a co-owner, the broker will share in the *spendable income* produced by the property. Also, the value of his **percentage ownership interest** will inflate and appreciate over time. During the LLC ownership, he will receive fees for *brokerage services* rendered if the property is refinanced or sold, or if a co-owner decides to resell his fractional ownership interest, all commissionable events.

Thus, the broker sees a way to accomplish both of his personal objectives in one activity: syndication for the acquisition of an ownership interest in income property with cash investors. Through the syndication of income-producing property, he will build up his net worth as a landlord and receive additional flows of income from fees for management services and distributions of spendable income.

Is it permissible for a broker, acting as a syndicator, to receive contingency or percentage-based fees for rendering real estate brokerage services to a group of co-owners when he is himself a co-owner of the property acquired, operated and eventually sold?

Yes! The syndicator holds a California real estate broker license. A licensed broker acting as an asset manager on behalf of the co-owners (or the LLC) may charge fees that are **based on a percentage** and **contingent** on the rents collected, the price received on a resale of the property or the amount of any loan he arranges. As a co-owner who is a broker, the syndicator is not restricted to a salary or a fixed dollar amount paid periodically as compensation without regard to the rents collected, loan amounts or the resale price. [California Business and Professions Code §10131]

However, the fees the syndicator expects as payment for future services must be agreed to in either the LLC operating agreement or a written management agreement. These agreements are entered into when forming the LLC. A separate listing agreement should not be used and is not needed for the syndicator to be able to enforce collection of the fees. Further, any compensation the broker will receive, whether acting as a principal in ownership or as a broker rendering services, must be disclosed in the investment circular (IC) used to solicit investors.

An unlicensed person may manage the property for the co-owners with compensation based on a fixed monthly fee or salary. However, the unlicensed manager may not receive **incentive-based amounts** for compensation, such as a percentage-based fee tied to the amount of rent collected, an occupancy rate, minimum spendable income or other production-based formula. [Bus & P C §10133(a)(1)]

The advantages of being licensed

A real estate broker who forms investment groups needs to analyze the long-term role syndication will play in their professional career. Syndication is a source of mixed income: part of the income comes from the ownership of fractional interests in real estate and part comes from fees for brokerage services. However, the licensee negotiating the purchase of property and soliciting investors for that purchase will soon experience an indirect benefit for having earned a license and the right to conduct business as a broker. He will be viewed as having achieved the necessary credentials to authorize his activities.

Members of the public who have accumulated cash savings and are considering other investments generally understand that a person licensed as a broker has been in the real estate business for some time, and is not a newcomer seeking a quick buck or learning at the expense of unwitting investors. They presume the broker has attained some advanced level of technical training and education to qualify for a broker license — as he has.

When a prospective investor is solicited by a broker to join him in the co-ownership of a property, the investor presumes the broker is a licensed professional who has experience working with fellow licensees:

- locating property;
- negotiating purchase agreements;

- arranging financing and leasing; and
- managing property.

These points of expertise are frequently taken for granted as being part of the qualifications requisite to becoming a licensed broker.

Thus, a broker has **something to lose** if he is incompetent — or worse — fraudulent in his representation of the values and attributes of property. A broker's exposure to loss of his license for improper conduct greatly reduces the investor's risk of the moral hazard of investing with a syndicator who does not invest his own cash and would not otherwise suffer if the investment fails for known, readily discoverable or avoidable defects.

Further, brokers carry, or should carry, professional **malpractice insurance**, called *errors and omissions coverage*. The coverage should be disclosed to their investors. Coverage for negligent misrepresentations, available to syndicators who are brokers but not to unlicensed syndicators, further places the investor's mind at ease about the integrity of the syndicator. The coverage provides a source of recovery beyond the investment if the investment is ill-fated for reasons of negligence in conducting a due diligence investigation, providing management services or tending to the care and protection of the property.

Holding a license also authorizes the broker to collect fees paid from the investor's initial contribution of capital, rental income, proceeds from the refinance or resale of the property, and for the professional services he provides.

The syndicator's task then is to live up to the **investors' expectations** by:

- negotiating the most advantageous price and terms for payment of the purchase price that are possible for the acquisition of income property;
- fully analyzing the property and documenting every aspect of a competent due diligence investigation;
- preparing a thorough representation of the advantages and disadvantages of the property that affect its value; and
- having the management experience needed to operate the property as a reasonably well-informed and prudent owner would.

For a syndicator, a broker license lends credibility and stature to his investment program.

Chapter 6 — Conflict of interest

This chapter demonstrates a broker's use of a Conflict of Interest Disclosure to avoid breaching the fiduciary duty he owes to his clients when he has a bias relating to other parties whose interests are in conflict with his clients'.

Professional relationships compromised

A conflict of interest arises when a broker or his agent, acting on behalf of a client, has a competing professional or personal bias which hinders his ability to unreservedly fulfill the fiduciary duties he has undertaken to advise and act on behalf of the client.

In a professional relationship, a broker's financial objective of *compensation for services* rendered by the broker is not a conflict of interest. However, fees and benefits derived from professional courtesies, familial favors and preferential treatment by others toward the broker or his agents is compensation which must be *disclosed* to the client. [See **first tuesday** Form 119]

Further, the referral of a client to a financially controlled business, owned or co-owned by the broker, must be disclosed by use of an affiliated business arrangement (ABA) form, and is also not a conflict of interest. [See **first tuesday** Form 519]

A *conflict of interest* addresses the broker's personal relationships potentially at odds with the agency duty of care and protection owed the client.

Thus, a conflict of interest creates a fundamental *agency dilemma* for brokers, not a compensation or business referral issue. A **conflict of interest** exists when:

- a broker has a positive or negative *bias* toward the opposing party in a transaction or a person indirectly involved in the client's transaction; and
- that bias in favor of or against the other person might compromise the broker's ability to freely recommend action or provide guidance to the buyer or seller, landlord or tenant, or lender or broker he agreed to represent.

This bias regarding an opposing person or a party not directly involved, to whom the broker may or may not also owe an agency duty, must be disclosed if the bias might disrupt the broker's ability to make impartial decisions about the care and protection he owes his client. Unless disclosed and the client consents, the conflict is a breach of the broker's fiduciary duty of good faith, fair dealing and trust owed to his client should the broker continue to act on the client's behalf. [See Figure 1 accompanying this chapter]

Situations involving a conflict

A conflict of interest, whether patent or potential, is disclosed by the broker at the time or as soon as possible after the conflict arises. Typically, the conflict arises prior to providing a buyer with property information or taking a listing from a seller.

The disclosure creates transparency in the transaction, revealing to the client the bias held by the broker which, when disclosed, allows the client to take the bias into consideration in negotiations. Though the disclosure and consent does not neutralize the *inherent bias* itself, it does neutralize the *element of deceit* which would breach the broker's fiduciary duty if left undisclosed.

Potential overlaps of allegiance or prejudice which cause a **conflict** that a broker or his agent must disclose include:

- the broker or his agent holds a direct or indirect *ownership interest* in the real estate, or are directly or indirectly a buyer of the property in the transaction, including a partial ownership interest in a limited liability company (LLC) or other entity which owns or is buying, leasing or lending on the property;
- an individual related to the broker or one of his agents by *blood or marriage* holds a direct or indirect ownership interest in the property or is the buyer;
- an individual with whom the broker or a family member has a *special pre-existing relationship*, such as prior employment, significant past or present business dealings, or deep-rooted social ties, holds a direct or indirect ownership, leasehold or security interest in the property or is the buyer;
- the broker's or his agent's concurrent representation of the opposing party, a *dual agency situation*; or
- an *unwillingness* of the broker or his agent *to work* with the opposing party, or others, or their brokers or agents in a transaction.

Simply, a **conflict of interest** arises and is disclosed to the client when the broker:

- has a **pre-existing relationship** with another person due to kinship, employment, partnership, common membership, religious affiliation, civic ties or any other socioeconomic context; and
- that relationship might hinder his *ability to fully represent* the needs of his client.

Unfortunately, comprehensive rules do not yet exist which establish those instances where a conflict of interest arises and needs to be disclosed. Thus, brokers are left to draw their own conclusions when situations regarding a property or a transaction with or involving third parties arise. In practice, brokers (and especially agents) all too often err on the side of nondisclosure, putting their brokerage fee, if not their license itself, at risk.

Generally, if a broker even questions whether it is appropriate to disclose a potential conflict of interest to a client, he should disclose it. The existence of any concern is reason enough for a prudent broker to be prompt in seeking his client's consent to the potential conflict. By timely disclosing a conflict of interest and obtaining consent, the broker immediately creates an honest working relationship with his client.

The client's tardy discovery of the conflict and their complaint to the Department of Real Estate (DRE) for failure to make the disclosure and obtain consent before continuing to advise or act on behalf of the client can result in the suspension or revocation of the broker's license by the DRE. [Calif. Business and Professions Code §10177(o)]

Fundamentally, a broker who becomes aware he has a conflict of interest but is reluctant to disclose it and seek the client's consent should consider rejecting or terminating the employment with that individual.

Figure 1

CONFLICT OF INTEREST

(Kinship, Position or Undue Influence)

NOTE: Licensed Brokers and Sales Agents when acting on behalf of a client may not act in a manner which might cause the client to conclude that others, or a position held by the Broker or his Agents, can improperly influence or cause the Broker or his Agents to fail to properly act in their fiduciary capacity as an agent without first disclosing to the client the facts which might otherwise lead to that conclusion and obtaining their consent.

DATE: _____________, 20______, at ____, California.

Items left blank or unchecked are not applicable.

FACTS:

1. This disclosure is made in connection with the following agreement:

☐ Listing (Employment) Agreement ☐ Purchase Agreement

☐ Escrow Instructions ☐ _____________________

1.1 ☐ of the same date, or dated _____________, 20______, at __________________________, California,

1.2 entered into by ____, as the __________________, and

1.3 ____, as the __________________,

1.4 regarding real estate referred to as ____.

2. The client(s) represented by the undersigned Broker with regard to the above referenced agreement is/are identified as the ____.

DISCLOSURE OF CONFLICT OF INTEREST:

3. Broker provides the following information as a disclosure to the client of relationships or positions held by Broker or his Agents, and their family members, in investments, business activities or real estate interests which present circumstances that might, if not disclosed, appear to be in conflict with the agency duty owed the client to care for and protect the interests of the client.

Check the following items and enter information on facts which are believed might create a conflict of interest for Broker or his Agents in performing their agency duties on behalf of the client.

3.1 ☐ Real estate

Property type: ____

Address: ____

Interest held: ____

Activity creating conflict: ____

3.2 ☐ Government agency

Agency name: ____

Position held: ____

Activity creating conflict: ____

3.3 ☐ Business position

Business name: ____

Goods or services provided: ____

Position held: ____

Activity creating conflict: ____

3.4 ☐ Business investment

Company name: ____

Type of trade or business: ____

Interest held: ____

Activity creating conflict: ____

— — — — — — — — — — — — — — — — — — — *PAGE ONE OF TWO — FORM 527* — — — — — — — — — — — — — — — — — — —

— — — — — — — — — — — — — — — — — — — *PAGE TWO OF TWO — FORM 527* — — — — — — — — — — — — — — — — — — —

3.5 ☐ Representation of others in transaction

Name of person also owed agency duties: ____

Activity creating conflict: ____

3.6 ☐ Kinship and employee relationships

Name of individual(s): ____

Relationship with Broker or employee: ____

Activity creating conflict: ____

4. Other disclosures of direct or indirect compensation or economic benefits may have previously been made, such as exists for additional compensation and controlled business arrangements. [See **ft** Forms 119 and 519]

BROKER:

5. I certify that the above information is true and correct.

Date: _____________, 20______ Broker's Name : ______________________________________

By: ____

Agent's Name: _____________________________________

CLIENT: I have received a copy of this disclosure and consent to continue the relationship with the broker as my agent.

☐ See attached Signature Page Addendum [**ft** Form 251]

Date: _____________, 20______

Name: ____________________________________ Name: ____________________________________

Signature: _________________________________ Signature: _________________________________

FORM 527 01-09

Relative's participation in a transaction

A seller's broker must disclose the broker's acquisition of any direct or indirect interest in the seller's property, or whether a family member, a business owned by the broker or any other person holding a special relationship with the broker (such as his agents) will acquire an interest in the seller's property. [See **first tuesday** Form 527 §3.6]

For example, a broker's brother-in-law makes an offer to buy property the broker has listed. The purchase agreement states the broker is to receive a fee and that he represents the seller exclusively.

The broker does not disclose to the seller that the buyer is his brother-in-law.

The broker opens two escrows to handle the transaction. The first escrow facilitates the sale and transfers the property from the seller to the broker's brother-in-law.

The second escrow is for the sole purpose of transferring title to the property from the brother-in-law to a limited liability company (LLC) in which the broker holds an ownership interest, a syndicated acquisition. Both escrows close and the broker receives his fee.

The seller discovers the buyer to whom he deeded the property was his broker's brother-in-law and that the true buyer was an entity partially owned by the broker. The seller demands a return of the brokerage fee claiming the broker had a conflict of interest which breached the fiduciary duty he owed to the seller since it was not disclosed and the seller did not consent.

Here, the broker is not entitled to retain the brokerage fee he received from the seller. Further, the seller is entitled to recover any property value at the time of the sale in excess of the price he received, or he can set the sale aside, due to the failure of the broker's agency with the seller.

A broker cannot act for more than one party in a transaction, including himself, without disclosing his *dual role* and obtaining the client's consent at the time the conflict arises. [Bus & P C §10176(d); see **first tuesday** Form 527]

Also, a seller's broker has an affirmative duty to disclose to the seller his agency or other conflicting relationship he might have with the buyer, even if the seller fails to inquire into whether the broker has a relationship with the buyer.

Further, failure to disclose a broker's personal interest as a buyer in a transaction when he is also *acting as a broker* on behalf of the seller constitutes grounds for discipline by the Real Estate Commissioner. [**Whitehead** v. **Gordon** (1970) 2 CA3d 659]

A relative owns the property sold

A selling broker employed to act on behalf of a buyer will disclose to his buyer the nature and extent of any direct or indirect interest he or his agents hold in any property presented to the buyer.

For example, a licensed broker acting as an agent on behalf of a buyer shows the buyer several properties, one of which is owned by the broker and others, vested in the name of an LLC. The broker promptly informs the buyer he has a listing on the property, but does not inform the buyer of his indirect ownership interest in the property.

The buyer later decides to purchase the LLC property. An offer is prepared on a purchase agreement form with an agency confirmation stating the broker is the agent for both the buyer and seller. The offer is submitted to the LLC. [See **first tuesday** Form 159]

The broker, aware the buyer will pay a higher price for the property than the initial price offered by the buyer, presents the buyer with a counteroffer from the LLC at a higher selling price. The buyer accepts the counteroffer

Here, the broker has a duty to promptly disclose his ownership interest in the property to the buyer the moment the conflict arises – the exposure of the buyer to the property. The conflict of interest in the broker's ownership is a material fact requiring disclosure since the buyer's decisions concerning acquisition of the property might be affected.

As a result of the lack of disclosure of the conflicting position of the buyer's broker, the buyer can recover the fee received by the broker and the increase in price under the counteroffer.

Had the buyer known the broker held an ownership interest in the property when it was first presented, he might have negotiated differently when setting the price and terms for payment, or he might have retained a different broker who was not compromised by a conflict of interest to represent his interests.

However, a broker acting solely as a principal in the sale of his own property is not restricted in his conduct by compliance with agency obligations. The broker selling or buying property for his own account should act solely as the seller or buyer, rather than pay himself a taxable fee for *also acting as a broker* in the transaction which then exposes him to claims of agency violations. [**Robinson** v. **Murphy** (1979) 96 CA3d 763]

Taking a fee when acting as a principal

When a broker-seller receives a brokerage fee on the sale of his own property or on the purchase of property for his own account, he subjects himself to real estate agency requirements.

For example, a broker sells a residence he owns which exists in violation of safety requirements for occupancy due to defects in the foundation known to the broker. The broker does not tell the buyer about the foundation defects.

Out of the proceeds the broker receives on closing the sale of his property, the broker-seller pays himself a brokerage fee, claiming to *exclusively represent himself* (which is not an agency and does not require a license).

The buyer later discovers he must demolish the residence and rebuild it with an adequate foundation. The buyer obtains a money judgment against the broker for breach of his general agency duty owed to all parties in a real estate transaction to disclose known property defects that cause the buyer to take a loss.

The broker is unable to pay the money judgment. The buyer seeks payment from the DRE Recovery Fund.

Recovery is received from the DRE Recovery Fund since the broker held himself out as a**cting as a real estate broker** in the transaction – he received a fee. The broker's license is then suspended. Before the broker can reactivate his license, he must reimburse the DRE Recovery Fund. [**Prichard** v. **Reitz** (1986) 178 CA3d 465]

The licensee acts solely as a principal

A DRE licensee acting solely as a principal on his own behalf when buying (or selling) property need not disclose the existence of his real estate license. The licensee has no conflict due to the **existence of his license** since he is not holding himself out as a broker or agent acting on behalf of another person in the transaction.

Consider a broker who is employed by an owner to arrange a real estate loan. The lender making the loan is the broker's sister.

The broker, however, funds the loan himself by depositing his personal funds into his sister's account. In essence, the broker is the lender.

The owner is not advised of the kinship between the broker and the lender, or of the true source of the loan funds. [See **first tuesday** Forms 205-1 and 205-2]

Here, the broker has a duty owed to the buyer to disclose his **dual capacity** in the loan transaction. He was acting both as a broker arranging the loan on behalf of the owner and as the lender making the loan, a conflict of interest. The broker's actions constitute grounds for discipline by the Real Estate Commissioner. [**Tushner** v. **Savage** (1963) 219 CA2d 71]

Conflicts in real estate syndication

A potential conflict of interest also exists when a broker manages multiple LLCs which own like-type properties in the same market area, the result of his syndicating the acquisition of several properties.

For example, consider a broker entrusted with managing two investment groups which own similar apartment projects located within the same market and compete for the same prospective tenants. The broker is paid a management fee by each investment group based on a percentage of the rents received.

When contacted by a prospective tenant, the broker is initially faced with the dilemma of which apartment building to refer the tenant to and thus which investment group will benefit from the tenant's occupancy.

A similar conflict of interest results from parallel transactions in which multiple LLCs managed by the same broker are actively competing to sell or buy property within the same marketplace.

A conflict of interest of this nature must be disclosed to the investors before they agree to participate as members in an LLC the broker manages. This disclosure is contained in **first tuesday** Form 371, Investment Circular provision 6d, which states:

- The Manager has numerous other business responsibilities and ownership interest which will demand some or most of his time during the LLC's ownership of the property. The Manager's other interests include ownership of projects comparable to the property purchased in this transaction. To the extent his time is required on other business and ownership management decisions, he will not be involved in monitoring or marketing of the LLC's property. [See **first tuesday** Form 371]

With this disclosure, the broker's allegiance to multiple projects and investment groups is transparent and can be taken into consideration by all investors at the time they receive the Investment Circular from the Broker – before investing and consenting to the risk.

Compensation and earnings received by the broker

Direct or indirect compensation received by a broker must be disclosed to his client but not as a conflict of interest. A Compensation Disclosure form is prepared, setting forth the amount of compensation, its form and source as additional benefits the broker and his agents anticipate receiving for any other service they provide as a result of the client's entry into a real estate transaction in which the broker is acting as a licensee. [Bus & P C §10176(g); see **first tuesday** Form 119]

Additionally, a broker listing a property or representing a buyer who refers the owner or buyer to a business or service provider he owns or co-owns uses an Affiliated Business Arrangement Disclosure Statement to inform the party of his ownership interest in that company. The disclosure enables the broker to indirectly benefit from the referral and properly share in any profits from the referrals he makes to businesses he controls. [See **first tuesday** Form 519]

Chapter 7 — Retaining a real estate attorney

This chapter reviews the process for locating, interviewing and retaining an attorney to advise and render services in real estate disputes confronting broker-syndicators.

Choosing the right one

Oftentimes in syndication activities, it is necessary or advisable for the syndicator, the investors or the LLC as a group to seek the legal counsel of an attorney.

Consider a syndicator faced with a dispute arising out of his activities as a manger/investor in a real estate syndicate. He requires advice from an attorney with legal expertise in the analysis and resolution of real estate conflicts.

The broker has never sought out the professional advice of an attorney and does not know how to go about locating or selecting a qualified one.

What steps should the broker take to select a competent attorney? What law office procedures should he look for when first meeting with an attorney? What can he expect to encounter when retaining an attorney?

Selecting an attorney

To initiate the attorney **selection process**, the broker should talk to several active real estate brokers in the area where the affected real estate is located. The brokers should be asked for the names of three or four real estate attorneys they are familiar with and feel confident referring someone to for advice on real estate and agency matters, especially of the type confronting the broker.

The broker should further inquire into the different areas of real estate law each attorney appears to be engaged in, the types of cases they handle and the competence demonstrated by the attorney as observed by the brokers he contacts. The recurrence of the name of one attorney who is consistently recommended by the brokers contacted is generally a helpful indication of the most qualified attorney.

While attorney referral services and media advertising may be helpful in the initial selection stage, it is difficult to obtain objective recommendations or criticism from these typically biased sources.

It may even be necessary to locate an out-of-area attorney who specializes in the particular type of legal situation confronting the broker due to the sensitivity of local attorneys.

Regardless of locale, at least two or more attorneys should be selected and phone or office conferences should be arranged.

Before (and after) selecting an attorney, it is both proper and prudent for the broker to contact yet another attorney and hold a telephone conference as a "brainstorming session." This would provide a second opinion — and an additional or alternative advisor. The cost of conferencing with another attorney should be considered the premium paid for assurance that the broker and his selected attorney are on the right track, called *risk reduction*.

A client’s expectations

When meeting with an attorney, the broker should consider many aspects of the attorney’s law office, including:

- the compatibility of the attorney’s personality with his own;
- the attorney’s conversational skills;
- the efficiency and professionalism of the attorney’s work habits;
- the law office’s appearance (for example, does it appear organized and well equipped?);
- the courtesy, productivity and helpfulness of the secretarial staff; and
- the competency of the attorney’s law clerks or legal assistants to follow up on fact investigation, legal research, calendaring of events and related details.

The initial conference

During the initial conference with the selected attorney, the broker will discuss his real estate dispute as well as interview the attorney. This contact is the initial step to determine whether or not the broker feels this attorney is the best one for him to retain.

Relevant topics which should be discussed during the initial interview include:

- the attorney’s professional background and the types of legal disputes which make up his practice;
- the attorney’s previous experience with cases similar to the broker’s;
- whether his practice regularly calls for his appearance in the court which will hear the broker’s case;
- the attorney’s initial grasp and assessment of the facts and laws controlling the case;
- the outlook or probability of prevailing in the case;
- the different procedural stages, including negotiations, filing, discovery, trial and possible appeal;
- whether the dispute is covered by any insurance policies held by the broker;
- the potential liability exposure on an adverse result of the litigation;
- whether the prevailing party can collect his attorney fees from the other party;
- the attorney’s hourly fee and required *retainer deposit*;
- the estimated cost of handling the various stages in the resolution of the dispute; and
- the tax reporting permitted for the payment of the attorney fees.

At the same time, the attorney will also be deciding whether or not he wants to represent the broker.

Additionally, bearing on the broker's decision to retain the attorney are factors including:

- the attorney's own knowledge and experience with this particular type of case, and his rapport with the broker;
- whether or not, and why, the attorney believes he can obtain a favorable result for the broker; and
- whether the attorney has a conflict based on his other cases and clients.

The broker will typically be billed for this initial consultation on a per hour basis. Attorneys' hourly rates generally range from $150 to $400 per hour, depending on their location and expertise. Any time spent counseling with the attorney will cost the broker money.

The broker must also determine whether the attorney will handle the case himself or delegate the analysis and decision-making process to a subordinate or partner. If delegated, to whom and how closely will the attorney supervise the handling of the case?

The broker also needs to interview any associate attorney who will work on or actually handle his case. A prudent broker will include any associate attorney in the conference to avoid double billing.

The broker must be certain the attorney or associate he is going to employ has the broker's best interests in mind.

An attorney has the basic duty to respond promptly to any status inquiries by the broker and keep the broker reasonably well informed, monthly if possible, on matters relating to the case. [Calif. Business and Professions Code §6068(m)]

If the attorney interviewed is not retained to represent the broker, the attorney still has the duty to maintain confidentiality of the information exchanged between him and the broker. [Bus & P C §6068(e)]

Retainer agreements

Once an attorney has been chosen, the broker will be asked by the attorney to enter into a *retainer agreement* employing the attorney. The attorney has a statutory right to collect a fee for his legal services. [Calif. Code of Civil Procedure §1021]

The attorney should fully explain the amount of fees or basis for their computation before the fee agreement is signed by the broker. To be enforceable, fee agreements for attorney services must be in writing when it is known the attorney fees will exceed $1,000. [Bus & P C §6148(a)]

Thus, written **retainer agreements** must contain:

- the hourly rate and other rates, fees and applicable charges;
- the nature of the services to be provided; and
- the respective responsibilities of the attorney and broker in performance of the retainer agreement. [Bus & P C §6148(a)(1-3)]

All billings for services must be itemized by naming the activity performed, clearly state the amount due and contain the hourly rate or basis of calculation used to determine the fees. [Bus & P C §6148(b)]

If a *contingency fee* agreement is negotiated, the agreement must be in writing and contain:

- a statement of the **contingency fee** rate;
- a statement addressing how disbursements and costs incurred in connection with prosecuting or settling the case will affect the amount of the contingency fee and the broker's recovery;
- a statement addressing what extent, if any, the broker could be required to pay attorney fees for related matters not covered in the fee agreement; and
- a statement the fee is negotiable and not set by law. [Bus & P C §6147(a)(1-5)]

A duplicate copy of the contingency fee agreement signed by the attorney and broker must be given to the broker. Failure to provide this information will render the retainer agreement voidable at the option of the broker. [Bus & P C §6147(b)]

Later, if the broker has grounds and chooses to void the contingency fee agreement, the attorney will be entitled to collect a reasonable fee from the broker based on the time spent on the case. [Bus & P C §§6147(b), 6148(c)]

The retainer agreement can also be signed by and given to a representative of the broker, such as his office manager. [Bus & P C §6147(a)]

Written fee agreements are confidential contracts between the attorney and his client, in this example the broker. [Bus & P C §6149]

Deductibility of legal fees

Deductibility of legal fees for tax reporting is determined by the activity causing the expense. If not deductible, the legal fees are either **personal losses** or a **capital investment** added to the cost basis of the property involved.

Legal fees fall into four federal tax reporting categories:

- personal expenses;
- business expenses;
- real estate rental (passive) expenses; or
- investment portfolio expenses.

Legal fees incurred for consultation on a broker's business-related matter are fully deductible as an expense of earning brokerage fees, the trade for which he holds a broker's license.

Legal fees incurred in the management, conservation or maintenance of income-producing real estate — rentals — or for the production or collection of rents, are **deductible** from rental income, a passive income category activity, as an expense. [Internal Revenue Code §212]

However, legal fees incurred in connection with zoning battles, title defenses, condemnation or acquisition must be *capitalized*, not expended. These expenditures are added to the property's basis as they are considered **capital expenditures**, not operating costs. [**Soelling** v. **Commissioner** 70 TC 1052]

Legal expenses incurred to preserve ownership or defend title to an owner's personal residence are **non-deductible** personal expenses.

When employing an attorney, it is prudent for the broker to ask for his advice on the tax deductibility of his fees and, in contingency cases, the reporting of the attorney's share of any recovery.

Itemized billings

The broker should ask for and review a typical or prototypical billing statement used by the attorney.

The billing statement should be itemized, describing each legal activity or service provided by the attorney or his staff, the date the service was performed, the time spent rendering the service and the fee charged or the cost of each item.

The statement should also state the amount due and the hourly rate or other basis for calculating the fees. [Bus & P C §6148(b)]

Should the broker request a billing at any time, the attorney must provide one within ten days following the request. [Bus & P C §6148(b)]

The broker is entitled to receive invoices at intervals of no less than 30 days following his initial request for a billing statement. [Bus & P C §6148(b)]

The attorney's failure to meet these requirements will render the fee agreement voidable at the option of the broker. However, if the broker elects to void the retainer agreement, the attorney will be entitled to collect a reasonable fee. [Bus & P C §6148(c)]

Other factors influencing selection

Additional factors the broker should consider before selecting an attorney to represent him include:

- the attorney's familiarity with real estate law and how up to date he is on any statutory, case law and regulatory changes;
- if the attorney will review the file on a monthly or other periodic basis;
- if the attorney will automatically provide the broker with copies of all correspondence, documents and papers related to the case, and at what cost;
- if the attorney will consult with the broker on any substantial issues which may arise before he makes a decision or takes action; and
- if the attorney will review insurance policies (i.e., homeowner's policies, business insurance, errors and omissions insurance) to determine if legal fees are covered.

If the dispute is covered by insurance, the insurance carrier may reserve its right to choose the broker's attorney. However, in some circumstances involving the insurance company's issuance of a reservation of rights, the broker is allowed to select his own attorney in addition to the attorney selected by the insurance carrier.

Chapter 8 Selecting suitable investors

This chapter analyzes a syndicator's need to associate with a few congenial investors who desire a long-term investment and appreciate the ownership risks of a cyclical investment.

Profiling for investment longevity

Investors do some amount of background investigations and are fairly selective when they consider entrusting a real estate syndicator with the on-going management of the capital they contribute.

Likewise, a syndicator should collect information regarding the attributes of each potential investor he solicits to join in the investment with him. An analysis of **character types** for selection and solicitation of qualified investors allows the syndicator to enhance his chances for long-term success in his investment programs.

Personal information on potential investors is typically compiled by the syndicator over time. It is then retained on an investor profile form prepared on each potential investor. The completed forms are placed on file in a database of prospective investors. [See Form 350 accompanying this chapter]

Before soliciting investors for a particular property acquisition, the syndicator must set a limit on the **number of members** he would like to participate. Three to six cash investors seem to be the preferred range. The more investors brought into a group, the more likely there will be difficulties communicating with each member and managing co-ownership issues when they arise.

To maintain equilibrium of influence within the group, the amount contributed by each investor should be nearly the same amount as contributed by the other investors. Thus, no one investor has implicit undue influence to dominate the conduct of group activities. A general rule suggests no one investor should have more than twice as much invested as any other single investor. Ideally, all investors should make identical amounts of cash contributions to the investment. All investors will then be more likely to treat each other equally.

When soliciting investors, the syndicator should consider each individual's financial capacity and long-term propensity to stay with an investment in real estate. If a prospective investor has cash but is not creditworthy, he may be unreliable as a long-term participant due to potential future demands on his invested capital by creditors.

Also, if additional contributions are later needed to carry the limited liability company (LLC) through a cyclical negative cash flow period, the financially unstable investor may be unable or unwilling to further contribute.

An individual's negative creditworthiness condition usually results from a failure to look ahead at the consequences of his doing nothing, a prelude to lost opportunities for all connected with him in an investment program. Especially trying for some erstwhile investors is the stress of the local economy moving through a cyclical recessionary period when property underperforms.

When selecting prospective investors, be skeptical of any investor who appears to be disinclined to compensate the syndicator for his promotional and administrative activities. The individual probably views

CLIENT PROFILE
Confidential Personal Data Sheet

NOTE: Use of this form assists in collecting information about an individual's personal traits, family obligations, composition of wealth, community integrity and accomplishments to better inform the Broker/Agent about the individual's wants and needs.

DATE: _____________, 20______, at ____, California.

1. **Personal information:**
   1.1 Name ____
      a. Address ____
      b. City ______________________ State ____________ Zip ____________
      c. Phone ______________ Fax ______________ Email ______________
      d. Age _______ General health ____________________________
      e. Length of time in the community ____________________________
      f. Personal achievements ____________________________
   1.2 Occupation ____
      a. Professional designations & licenses ____________________________
      ____
      b. Business address ____
      c. City ______________________ State ____________ Zip ____________
      d. Business phone ______________ Fax ______________ Email ______________
   1.3 Marital status ____
      a. Spouse's name ____
      b. Spouse's occupation ____
      c. Children – names & ages ____
      ____
   1.4 Membership in cultural or civic organizations ____________________________
      a. Religious preference/time dedicated ____________________________
2. **Financial information:**
   2.1 Gross annual income . . . . $______________
   2.2 Interest income . . . . $______________
   2.3 Dividend income . . . . $______________
   2.4 Spendable income (real estate) . . . . $______________
   2.5 Approximate net worth
   (excluding home, car and furnishings) . . . . $______________
   Cash on deposit . . . . $______________
   Liquid stocks & bonds . . . . $______________
   Net equity in real estate . . . . $______________
   2.6 Investor can make additional capital
   contributions in the annual amount of . . . . $______________
   Source of funds ____
   2.7 Cash value of life insurance . . . . $______________
3. **Investment background:**
   3.1 Stocks, bonds or commodities ____
   ____
   ____
   3.2 Real estate owned other than residence ____________________________
   ____
   ____
   3.3 Investor involvement in partnership(s) ____________________________
   ____
   ____

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4. Investment needs (explain briefly):

4.1 Tax benefits ____

____

____

4.2 Spendable income, loan reduction or increased value ____

____

____

4.3 Short-term investment goals (less than 5 years) ____

____

____

4.4 Long-term investment goals (five or more years) ____

____

____

5. Investor's advisors:

5.1 Accountant ____

5.2 Insurance broker ____

5.3 Banker ____

5.4 Attorney ____

5.5 Stockbroker ____

5.6 Real estate broker ____

6. Educational background:

6.1 Degrees and majors ____

____

6.2 Real estate or law courses studied ____

____

____

7. Investor's special interests (hobbies, clubs, etc.):

____

____

____

8. Personality traits:

8.1 Positive and decisive? ☐ Yes ☐ No

8.2 Negative and evasive? ☐ Yes ☐ No

8.3 Passive and compliant? ☐ Yes ☐ No

9. Relationship with broker:

9.1 Brief description of previous relationships (business, social, civic) with investor: ____

____

____

____

FORM 350 04-08

the syndicator as suspect. As a member in an LLC, the suspicious investor is more likely to later blame the syndicator for an adverse shift in local market conditions and be unwilling to remain in the investment or contribute additional capital on a call from the syndicator.

Investor uniformity

Investors who are selected by the syndicator should be:

- *objective* in their approach to problem solving and not prone to act on their emotions;
- *goal-oriented* when analyzing the syndicator's expectations for ownership of the property and looking forward into the economic future for the property;

- *willing to commit* their capital and share earnings (or losses) of ownership as a group, an acknowledged joint effort from the start;
- *willing to leave* the day-to-day management of the program to the syndicator, as authorized by the operating agreement and the property management agreement; and
- *willing to provide* the syndicator with a fair and competitive amount of compensation in ownership and cash for his acquisition and management efforts.

A group of investors from **comparable backgrounds** is more likely to produce a smooth running investment program in spite of cyclical shifts in the economy. Socioeconomic similarity between investors safeguards against inconsistent investment attributes and expectations. To ensure investor uniformity, a syndicator should consider the following:

- location of their residence (preferably within the same community);
- age group — younger investors are more likely to accept and absorb high risk investments, whereas older, more stable investors who have accumulated their net worth over a long period of time are less likely to take such risks;
- extent of their personal achievements;
- economic standards (similar personal net worth, annual income and family needs);
- business background, occupational experience and creditworthiness;
- level of formal education;
- longevity of their family in the community; and
- prior investment, civic and social activities.

The geographic location of the investor is a consideration in choosing an investor. However, in the increasingly global economy, it should not be taken for granted that investors from different locations may also have the required temperament, experience and other characteristics necessary to undertake California real estate investments. No restrictions exist which prohibit domestic or foreign nonresidents from owning a membership interest in California real estate syndicates. There are, however, additional tax considerations when involving nonresident members in an LLC. [See Chapter 16]

The weeding process

Some prospective investors possess characteristics that are not accommodating or desirable in an LLC syndication program. The syndicator should avoid prospective investors who demonstrate:

- an *improper emotional makeup* to remain in a long-term investment;
- a suspicious or nit-picking (micro-managing) *attitude that conflicts* with the profit-sharing, joint-venture theme of a group investment program, manifested by asking detailed questions about the syndicator’s day-to-day operations of the property that appear designed to “catch” him in inconsistent explanations rather than honestly trying to better understand the long-term risks of loss the real estate or the economy may present for the investment; or

- an *excessive concern* for the *modus operandi* of the syndicator, making inquiries with the apparent intention of learning enough from the syndicator about his property selection analysis and the organizational requirements for forming an investment group to enter the real estate investment field himself as a promoter and micro-manager of capital raised from his acquaintances.

Chapter 9 — The distribution of income

This chapter reviews each member's ownership share in the limited liability company based on the percentage their capital contribution represents of the total of all forms of member contributions.

Contributions set share of ownership

Consider a limited liability company (LLC) that is initially capitalized at $500,000–$400,000 in **cash** contributed by the investors and $100,000 in the value of the syndicator's contribution by **assignment** of his right to purchase the property acquired by the LLC.

The cash investors receive Class A *priority* membership interests in the LLC set at $400,000. In contrast, the syndicator receives a Class B *subordinated* membership interest in the LLC set at $100,000 for the **property rights** he assigned to the LLC.

The combined capital contributions of all members is $500,000, comprised of the cash contributions ($400,000) of the Class A cash investors and the Class B contribution ($100,000) of the syndicator. The ratio of each member's contribution to the total of all contributions to the LLC sets his percentage of ownership in the LLC. Thus, the Class A members collectively hold an 80% participation in ownership; the syndicator, a 20% participation.

The vesting of ownership to the property purchased will be in the name of the LLC, not the members or the syndicator. The members own the LLC, not the real estate, unless the stated purpose of the LLC is to hold title in trust for the members as tenants in common who then co-own the real estate.

From the $400,000 in cash contributions, $340,000 is used as a down payment to fund the acquisition of the property — funds the LLC needs to close the purchase escrow and acquire title.

Also from the cash contributions, $30,000 is placed in a reserve account the LLC maintains. From the reserve, the LLC pays miscellaneous closing costs, attorney fees, accounting fees, printing costs and other out-of-pocket **transactional expenses** incurred to create the LLC and purchase the property. The balance remaining unused in the reserve account after payment of transactional costs serve as a contingency fund for unexpected operating expenses that typically confront a new owner of property.

The remaining $30,000 is paid to the syndicator as a fee to compensate him for his **time and effort** spent soliciting investors to become members and fund the LLC. The cash fee is in addition to his 20% subordinated membership interest received in exchange for the assignment of his contract right to purchase the property.

The syndicator's contribution and share

Typically, a syndicator is not also a cash investor. The dollar amount of the **membership share** he receives in the LLC is based on the dollar value the syndicator places on the contract right he assigns to the LLC to purchase the property. In exchange for the assignment, the syndicator receives a dollar amount of Class B subordinated interest in the LLC, the requisite to establishing his percentage share of membership.

The cash investors — one of whom could be the syndicator if he also contributes cash — hold Class A memberships. As cash contributors, Class A investors receive a **priority distribution** of earnings under the LLC operating agreement, including:

- **spendable** income from operations; and
- **net proceeds** from the refinance or resale of the property.

For example, the operating agreement entitles the Class A members to first receive a distribution of annual spendable income generated by the property. Only then may the syndicator (and any other Class B member) receive spendable income. This priority distribution to Class A members is limited in amount to an annual percentage on their cash contribution, a *cash-on-cash* return comprising capital (due to depreciation deductions) and ordinary income.

The spendable income the syndicator receives as his **subordinated distribution** is the same annual percentage return on the dollar amount of his contribution as the Class A investors have received on theirs.

Any spendable income then remaining is next distributed among all the members pro rata, based on the percentage share they hold in the LLC without concern for priorities or subordination, called a *parity distribution*.

However, a different ratio of sharing between classes is occasionally established for these parity distributions. For example, the spendable income remaining after priority distributions might be distributed 50% to Class A members and 50% to Class B members.

Thus, the syndicator has greater incentive to increase spendable income, since he will share in spendable income disproportionately to ownership and for his greater benefit. This self interest in increasing spendable income in turn increases the property's value. Over time, and due to inflation's effect of driving up rents and spendable income, these alternative percentages for sharing can shift great wealth to the syndicator.

Distribution of the net proceeds from a refinance or sale of the LLC property follows a similar priority format for sharing. The Class A members receive the first distribution of proceeds from a refinance and sale up to the dollar amount of their original contributions, plus any unpaid minimum annual distributions. Any portion of the annual minimum rate of return that is not distributed during prior periods of ownership accumulates and is distributed as funds from any source become available.

Next, the Class B syndicator receives a distribution from the refinance and resale proceeds up to the dollar amount of his capital contribution, plus any annual minimum rate of return that has not been distributed and has accumulated unpaid.

Any proceeds that remain are typically distributed on a parity basis to all members. For example, the agreement may call for the remaining funds to be distributed to all members based on their percentage of membership, or on a different ratio, such as a 50-50 split between the Class A and Class B members or any other ratio agreed to.

Finally, the manager, as a licensed real estate broker, may receive a fee on the management, refinance, and sale of the property. The right to a fee must be contracted for in the operating agreement. As payment for services, the distribution of brokerage fees has priority over distribution to capital investors.

Chapter 10 Sharing through services and capital contributions

This chapter presents the compensable activities of a syndicator, the methods for payment of that compensation and arrangements for sharing income and profits with the co-owners.

The tradeoff in priority distributions

An income property produces an annual *net operating income (NOI) or loss* during any given time period, no matter how well managed it may be. During the same period, the property will experience an annual rise or fall in the dollar amount of its fair market value. Value fluctuations are triggered by national price inflation and local appreciation for the property, again with no correlation to the management of the property.

For the owner, the NOI and any rise in value make up the sum of the earnings generated by the property during any given period of time.

When an income property is co-owned by investors and a syndicator, the earnings produced annually by rental income and rising property value are shared between them. Any increase in one co-owner's share of the earnings, such as the syndicator's share, produces an **equal decrease** in the earnings remaining available to the other co-owners, such as the investors, a perfect example of a *zero-sum game*.

Here, in the environment of a syndicated investment, that portion of the property's earnings (NOI and value) taken by the syndicator reduces the amount of rental income and property value available for disbursement to cash investors. On the other hand, a **priority allocation** of spendable income, loan reduction and increased property value to cash investors draws down the earnings available for distribution to the syndicator. Thus, all co-owners share, under one form or another, in an **absolute sum** of dollars represented by the NOI remaining after interest expenses and any rise in value generated by the property.

Share and share alike

Consider the amount of $300,000 as a down payment a syndicator has negotiated for the purchase of a property. The down payment is funded by contributions of $50,000 from each of six investors who join with the syndicator to co-own the property. The syndicator receives a $50,000 share in ownership for locating the property and contracting to purchase it. The total capital contribution from all members and in all forms is $350,000.

Any percentage of the income and profits the syndicator is to receive for his share of ownership reduces the earnings available to the cash investors who funded the entire down payment made to acquire the property.

Here, the cash investors put up 100% of the funds needed to buy the property, but receive only 86% of the ownership. The syndicator's $50,000 co-ownership valuation represents 14% of the total $350,000 capitalization of the investment group. Thus, the purchasing power of the investor's cash has been diluted by the percentage of ownership held by the syndicator, referred to as *watered stock*.

The property is acquired by the group at its current fair market value. Further, the syndicator receives no part of the down payment from the seller or anyone else, such as a lender, the listing broker (or seller), a title company or other provider of services for the purchase transaction. Thus, the syndicator

receives no compensation or benefits for his efforts, other than the percentage of co-ownership he was able to justify to the satisfaction of the cash investors as the value of his purchase rights assigned to the limited liability company (LLC). He will receive 14% of all distribution of income and profits.

The moral hazard in parity sharing

To continue, consider the sale of the same income property by the group one year later. The price received reflects an increase in value equal to the transactional costs incurred to sell the property (an increase of approximately 6%). Thus, the net proceeds from the resale are $300,000.

On distribution of the net sales proceeds to the investment group composed of the syndicator and the six investors, the syndicator will receive his piece of the action: 14%, or $42,857. The investors will receive the 86% remainder of the proceeds, or $258,000. Thus, each of the investors who funded the entire down payment will receive $42,857 as the return of their $50,000 investment, resulting in a cash loss on the sale exceeding $7,000 apiece.

Here, the investors acquired *parity ownership* with the syndicator. Parity allows the syndicator to share and share alike with the investors all the net cash on the resale, creating a *risk of loss* known as a **moral hazard.** The syndicator will receive cash on any sale without concern for the quality of the property selected, the day-to-day operations, care of the property or the effective marketing of the property to obtain the highest resale price.

A syndicator who shares in the net sales proceeds is on a **parity basis** with the investors. His compensation is not contingent on his performance or subject to a priority return of the investors' cash contributions. The **risk of loss** situation created by parity participation allows the syndicator to merely sit and wait for a sale in order to benefit financially from his initial syndication efforts.

The likelihood of a financial return

Investors need to be provided with a reasonable likelihood their invested capital will be returned to them together with the income and profits they have been led to anticipate on their investment. To attain these objectives, the investment program needs to include a mix of:

- cash distributions based on a mix of priorities, subordination and parity participation between all co-owners;
- front-end reimbursement of the syndicator's out-of-pocket expenditures for acquisition (transactional) costs, LLC organizational expenses and purchase agreement deposits;
- participation by the syndicator as a co-owner in lieu of a cash payment for the assignment of his purchase rights to the LLC;
- fees for services performed by the syndicator to form the LLC, prepare an investment circular (IC), locate investors and for property management during ownership of the property;
- cumulative minimum annual earnings on contributions;
- separate classes of ownership for the different tiers of sharing arrangements; and
- fees and earnings due the syndicator based on graduated percentages for achieving higher levels of income and profit.

Also encouraging for investors is an investment program that lacks:

- parity participation between the investors and the syndicator in distributions [See Chapter 9]; and
- up-front fees to the syndicator exceeding the reimbursement of his out-of-pocket costs for LLC organization and transactional costs of property acquisition.

The phases of a syndicated investment

As a prerequisite to structuring the sharing of earnings and wealth flowing from a property, a dollar value must be placed on the syndicator's participation in ownership. Once the dollar value is set, the **percentage** of each co-owner's contributions to the total of all contributions made establishes the basis for participation in income, profits and the return of capital.

The following outline chronicles the activities that go on during the three phases of the **syndicator's participation** in a syndicated investment program:

Phase 1. The pre-acquisition period

1.1 Search for and locate suitable property.

1.2 Select a property that appears suitable to acquire based on unconfirmed seller disclosures.

1.3 Enter into a letter of intent or an agreement to purchase the property at a price (which includes a brokerage fee payable to the syndicator for his services).

1.4 Complete a due diligence investigation and either terminate negotiations and cancel the agreement, or proceed to perform the purchase agreement.

1.5 Dictate and execute escrow instructions to process the closing of the purchase agreement.

1.6 Deposit good-faith money in escrow and arrange mortgage financing.

1.7 Prepare an IC.

1.8 Prepare the LLC (or tenancy-in-common) operating agreement, setting the ratios and formulas for investor and syndicator participation in earnings.

1.9 Solicit commitments from investors to contribute cash.

1.10 Record the LLC articles when the investment is fully subscribed.

1.11 Assign the syndicator's right to purchase the property to the LLC.

Phase 2. The ownership period

2.1 The syndicator receives a share ownership in the LLC in exchange for an assignment of his purchase rights to the LLC, and the investors receive a share for their cash contributions.

2.2 Manage the property.

2.3 Experience equity buildup due to the amortization of the loan amount through monthly payments.

2.4 Distribute spendable income to the co-owners.

2.5 Refinance the existing loan and distribute any net loan proceeds and any resulting increase in spendable income to co-owners.

2.6 Buy out the investors on a right of first refusal or purchase option held by the syndicator.

Phase 3. The disposition period

3.1 Vote of the co-owners, authorizing the sale of the property.

3.2 Employ the syndicator as the listing broker to locate a buyer.

3.3 Prepare a marketing (listing) package for delivery of disclosures and representations about the property to prospective buyers.

3.4 Enter into a purchase agreement to sell the property and open escrow.

3.5 Assist the buyer in his due diligence investigation and close the sale.

3.6 Disburse brokerage fees to the syndicator from the net sales proceeds.

3.7 Distribute the remaining net sales proceeds to the co-owners.

3.8 Record the dissolution of the LLC.

The syndicator's earnings

An analysis that focuses on the economic nature of the syndicator's activities as **capital events** or **services rendered** is needed throughout this chronology of events. This economic analysis is a must when setting priorities, parities or accumulation of earnings and fees for sharing the property's rental income and rise in value.

To begin an analysis of the economic aspects of sharing, the syndicator's activities, which generate earnings during each phase of a real estate syndication, are broken down and categorized based on their nature as **capital contributions** to the LLC or **services rendered** on behalf of the LLC, differentiated as follows:

1. The syndicator's ownership activities acting as a principal:

1.1 *Acquisition phase:*

a. Enter into a purchase agreement in his own name (as the syndicator).

b. Open escrow to purchase the property in his own name.

c. Fund the good-faith deposit into escrow.

d. Transfer the rights to purchase the property by an assignment to the LLC.

1.2 *Ownership phase:*

a. Participate as a member who co-owns a share in the LLC.

b. Participate in the equity buildup in the property by the monthly amortized reduction in debt.

c. Share spendable income on its distribution to co-owners.

d. Share the net proceeds from a refinance on their distribution to co-owners.

e. Exercise the right of first refusal or option to buy the property or fractional ownership interests granted to the syndicator by the investors.

1.3 *Marketing and resale phase:*

a. Vote as a co-owner to sell the property.

b. Enter into a purchase agreement and escrow to sell the property.

c. Share the net sales proceeds on their distribution to co-owners.

d. Complete the dissolution of the LLC.

2. The syndicator's services rendered to the LLC acting as a broker:

2.1 *Acquisition phase:*

a. Prepare an IC to market LLC shares.

b. Arrange to assume or originate mortgage financing.

c. Solicit investors to contribute capital and enter into an LLC operating agreement.

d. Form the LLC by preparing, signing and recording the LLC-1.

2.2 *Ownership phase:*

a. Manage the property under a property management agreement with the LLC (or the investors).

b. Arrange any refinancing or further encumbrancing of the property.

c. Locate substitute co-owners on resale of an existing co-owner's fractional interest.

2.3 *Marketing and resale phase:*

a. Market the property for sale and locate a buyer under a listing agreement.

b. Prepare a marketing package to deliver property disclosures to prospective buyers.

c. Cooperate with prospective buyers during their due diligence investigations.

Rationale for sharing profits

When a syndicator decides to proceed with acquiring the property on completion of his due diligence investigation, an **IC** must be prepared. The IC will be used for marketing fractional ownership interests when soliciting contributions from cash investors. [See Chapter 20]

The IC includes an LLC **operating agreement** that authorizes the employment of the syndicator to manage the day-to-day operation of the property and the distribution of the earnings, profits and capital to co-owners.

However, before preparing the operating agreement, the syndicator must determine the nature and extent of his participation in the income and the earnings generated by the property and his management. To spur interest in the investment opportunity among prospective investors, the syndicator must demon-

strate that the formulas for sharing the earnings will, as a matter of priority distributions, deliver to the investors a minimum annual spendable income and a respectable portion of the profits on a refinance or resale of the property.

Collectively, the property's condition and income-sharing formulas must be sufficiently attractive to induce enough prospective investors to commit the funds needed to fully capitalize the investment, called *equity financing*.

For the risk of loss in an investment to be at an acceptable level for prospective investors, the syndicator must use substantially all the cash contributions to fund the down payment or the purchase of the property. To avoid creating moral hazards in his decisions, the fees or earnings due the syndicator must encourage him to work for results that exceed **minimum performance standards**. To do this, his ownership must be subordinated to disbursements to the investors from spendable income and net proceeds from a refinance or sale of the property.

Further, the syndicator must make his case that the dollar amount of his contribution to ownership, when set as the value of the **purchase rights** he will assign to the LLC, is reasonable and based on objective standards of evaluation. He must also show that the fee he will be paid for his **organizational services** to form the LLC, solicit investors and bring together the co-owners is fair to the investors and competitive with fees charged by others who provide those services, such as attorneys.

Further, the **property management fee** he has bargained for must be shown as fair for the quality, quantity and reliability of his services, as compared to charges for like services provided by competitive property managers.

The syndicator must also provide his rationale for the minimum rate of return the investors will receive before he participates in any spendable income or profits generated by the property. It is he who will initially absorb the investment's risk of loss, as losses are first borne by him as a result of the priority distributions to investors.

Floors and ceilings on returns

Earnings are shared between the syndicator and the investors under various formulas. Sharing arrangements take into consideration priority and parity sharing, ratios for sharing, a minimum annual return that accumulates if unpaid, contingency fees, the dollar value of the syndicator's contribution and buy-out options. Collectively, these arrangements **place a ceiling** on the total return the cash investors receive over the life of the investment.

The following outline analyzes the various arrangements for sharing:

1. Structuring an LLC's capitalization and sharing by co-owners:

1.1 *The investors' contribution of cash provides for:*

a. A percentage of ownership in the LLC as Class A members.

b. A periodic distribution of spendable income between Class A and Class B members.

1) Initial priority distribution to Class A members.

2) Initial distribution as a minimum rate of return.

c. A supplemental distribution of remaining spendable income.

1) Parity distribution to members of all classes of any spendable income remaining after initial distributions to Class A and B members at the minimum rate of return.

2) Parity sharing by all members is based on percentage of ownership or another agreed ratio, such as 50:50 between classes.

3) Distribution of spendable income to Class A members may be capped at a maximum annual rate of return.

4) Spendable income remaining after distributions to Class A members at the maximum annual rate is distributed to Class B members.

d. An initial distribution of the net proceeds from a refinance or sale of the property.

1) Priority distribution to Class A members.

2) Initial priority distribution to Class A members limited to the dollar amount of their contributions and a minimum annual rate of return, less all distributions they have previously received.

e. Supplemental distribution of net proceeds remaining from the refinance or sale of the property after initial priority distributions.

1) Parity sharing between classes based on percentage of ownership or another agreed ratio, such as 50:50.

2) Distribution of the remaining net proceeds to Class A members may be capped at a maximum annual rate of return on their original capital contributions, such as a rate equal to the consumer price index (CPI) for the term of the investment and an annual percentage rate, such as 10% or 15%.

1.2 *The syndicator's contribution of purchase rights provides for:*

a. A dollar amount of ownership in the LLC as a Class B member.

1) The dollar value the syndicator places on his Class B membership received for his contract right to purchase the property establishes his percentage of ownership in the LLC.

b. A periodic distribution of spendable income to Class B members.

1) Distribution is subordinated to the annual floor rate of return initially distributed to Class A members.

2) The distribution is initially limited to an annual floor rate of return identical to the rate of return for priority distribution of spendable income to Class A members.

c. A supplemental distribution of remaining spendable income.

1) Parity sharing of spendable income between all classes.

2) The ratio for parity sharing is based on percentage of ownership or another agreed ratio, such as 50:50.

3) The parity distribution of spendable income to Class A members may be capped at a maximum annual rate of return.

d. A distribution of all remaining spendable income.

1) After initial and parity distributions to Class A and B members, any remaining undistributed spendable income is distributed solely to Class B members.

e. A subordinated distribution of proceeds from a refinance or a sale of the property.

1) Distribution to Class B members is subordinated to the initial priority distribution to Class A members.

2) Distribution to Class B members is limited to the dollar amount of their contributions and an annual minimum rate of return identical to the rate of return for priority distributions of proceeds to Class A members, less all distributions Class B members have previously received.

f. Supplemental distribution of net proceeds remaining from the refinance or sale of the property.

1) Parity distribution of proceeds between classes may be based on percentage of ownership or another agreed ratio, such as 50:50.

2) The amount of the parity distribution of proceeds to Class A members may be capped at an annual ceiling rate of return on their original capital contributions, such as a rate equal to the CPI for the term of the investment and an annual rate of return, such as 10% or 15%.

g. A distribution solely to Class B members of net proceeds remaining undistributed after priority and parity distributions to Class A and Class B members.

1.3 *Buy-out provisions represent:*

a. A right of first refusal granted to the syndicator in the operating agreement to acquire, at a formulated price, a co-owner's fractional interest on the co-owner's withdrawal, death, etc.

b. An option granted to the syndicator in the operating agreement to acquire the interests of the Class A members at a formulated price, comparable to a preferred stock arrangement by which a corporation pays off the stockholder. Alternatively, an option may be granted to the syndicator to buy the property from the LLC.

2. Fees and benefits for services rendered to the LLC by the syndicator:

2.1 *Acquisition fee or listing fee:*

a. Paid directly to the syndicator by the LLC out of cash contributions for brokerage services the syndicator rendered to negotiate the purchase, or less prudently, paid indirectly to the syndicator by the seller of the property out of the down payment.

b. Received by the syndicator in lieu of a percentage of ownership. [See §1.2a]

2.2 *Organizational or formation fee:*

a. Received by the syndicator from the LLC for services the syndicator rendered to prepare an IC, solicit cash investors and form the LLC entity.

b. Paid on the LLC's acquisition of ownership from cash contributions.

2.3 *Property management fees:*

a. Paid to the syndicator as a licensed broker at the end of each month in an amount based on a percentage of the rents collected.

b. Received by the syndicator as a licensed broker rendering services under a property management agreement.

c. Payment of the fee may be contingent on the sufficiency of rents to cover operating expenses and mortgage payments.

d. Payment of the fee may be further subordinated to the distribution of a minimum annual rate of return to the Class A members (an economically unsound treatment) and, if the fee is unpaid, will accumulate and be payable in later years when spendable income is available.

2.4 *Loan brokerage fee:*

a. Received by the syndicator as a licensed broker for arranging the refinancing or further financing of the property.

2.5 *Miscellaneous income and financial benefits:*

a. Received by the syndicator as reimbursement for expenses he incurred in the management of the LLC and the investors, other than the management of the property.

b. Received by the syndicator for providing services which are not obligations of the LLC under the leases. These services are paid for by tenants separate from the rent through common area maintenance fees (CAMs), a tenant association, laundry equipment and supplies or vending machines.

c. Profits from a maintenance company, controlled by the syndicator, that provides services for the care and maintenance of the LLC property.

d. Rent-free or rent-reduced occupancy of vacant space by the syndicator for his personal or business use, whether or not it is coupled with the management of the property.

2.6 *Sales fees or listing fees received by the syndicator as a real estate broker from the net proceeds on a sale of the property, paid by the LLC.*

3. A *master lease* held by the syndicator on the property acquired by the LLC:

3.1 *Rent paid to the LLC:*

a. Rent under the master lease is the sole source of a periodic return on the co-owners' invested capital.

3.2 *Right to buy:*

a. Rights of first refusal, buy-out options and options to purchase the property at a gain for the investors (in addition to rent) are granted to the syndicator to buy the property or buy out the cash investors.

Chapter 11 The tax treatment of a syndicator's earnings

This chapter reviews the taxation of a syndicator's earnings received in the form of an ownership participation or cash fees, structured as property rights or services rendered.

Property rights, services or both

A distinction exists between the income a syndicator derives from his *contribution of capital* to a limited liability company (LLC) and from *services rendered* on behalf of the LLC. The difference in the amount of taxes the syndicator will pay on earnings from **contributions** versus taxes on **services rendered** and when they will be due exemplifies the contrasts.

The syndicator's personal tax objective when structuring various syndication activities is to maximize his earnings from syndication activities while minimizing the tax impact they have.

For instance, the **profit taxes** the syndicator will pay "max out" at 15% (in 2009) on the resale of ownership interest the syndicator originally received for an assignment of his right to purchase the property. In contrast, the **ordinary income tax** on compensation the syndicator receives for services rendered while acting as an agent of the LLC max out at 35%, plus 15.3% in self-employment taxes and 9.55% in California state taxes.

As a result of the huge distortion in tax consequences, the syndicator's tax goal is to **contractually structure** his activities to attain the lowest allowable tax. The income he receives during the life of the investment program, from inception to resale of the property, is given the most favorable tax treatment if it is structured as a return on capital (profit), and not payment for services (ordinary income).

Rights created and exchanged

A syndicator packaging an investment opportunity establishes **property rights** when he enters into a binding contract to buy, finance or develop real estate in his own name. To contract, he uses purchase agreements, options, loan applications, construction permits or escrow instructions.

Property rights created and held by a syndicator are considered **capital interests**. Services rendered acting on behalf of another produces self-employed business income, which occurs when a syndicator negotiates a purchase agreement entered into in the name of the LLC and signed by the syndicator as its manager.

When a syndicator who creates and holds in his name a contract right to purchase a property assigns that right to an LLC in exchange for a membership interest in the LLC, that assignment is a tax-exempt transaction. Thus, the value of his property rights, established in his name as the buyer in the purchase agreement or option, is not taxed at the time the right to buy is transferred to the LLC. [Internal Revenue Code §721]

In exchange for the syndicator's contribution of his purchase rights by assignment, he may receive a *priority, parity or subordinated* ownership interest in the LLC. The tax consequences of a tax-deferred exchange of a capital interest for any priority of ownership interest in the LLC remain the same. How-

ever, the syndicator's contributions of his promotional or organizational services (time and effort) **spent on behalf** of the LLC for a participation in ownership are not tax exempt. Priorities are a huge concern when contributing services.

Consider a syndicator, acting as the named buyer, who enters into a purchase agreement (or option) to purchase property. The purchase agreement provisions allow the syndicator to assign his contract rights to purchase the property. Escrow instructions are then prepared and signed, naming the syndicator as the buyer.

On completion of his due diligence investigation and satisfaction of contingencies regarding the property's condition, the syndicator forms the LLC that will acquire the property. Through escrow, he then assigns his purchase rights to the LLC. In exchange, he takes **a percentage ownership** in the LLC.

The percentage of ownership he will receive in the LLC is based on the dollar value he places on the contribution of his right to buy the property by assignment. The dollar amount placed on his contribution then represents a percentage of the total of all forms of capital contributions to the LLC.

The syndicator's receipt of a membership share in payment for his assignment is a tax-exempt exchange transaction. [**Ungar** v. **Commissioner** (1963) 22 TCM 766]

Consider another property rights example. A syndicator-developer controls ground leases and loan commitments under contracts he entered into in his name. Before development begins, he forms an LLC and assigns it all his rights to purchase the leases, obtain the construction loan and develop the property.

The ground leases and loan commitments were the syndicator's assets, part of the net worth he developed for himself since they were initially created or controlled in his name, not the name of the LLC. The syndicator's contribution of these valuable property rights for an ownership interest in his newly formed LLC is a tax-free exchange. [**United States** v. **Stafford** (1984) 727 F2d 1043]

*Editor's note — A syndicator may purchase and assign property rights to a named LLC before the LLC is created. [**02 Development LLC** v. **607 South Park, LLC** (2008) 159 CA4th 609]*

Services rendered for a participation

Services rendered to the LLC include the syndicator's **time and effort** spent *on behalf of* the LLC to locate property and solicit investors to fund its purchase. Generally, the syndicator providing services to an LLC negotiates the purchase of property and enters into a purchase agreement or option — all in the name of the LLC. The syndicator signs the purchase agreement as the manager of the LLC.

The syndicator then sets a dollar value on his time and effort rendering services. His services are then contributed to the LLC in exchange for a membership interest with an equal dollar amount. He does not act in his own name as a principal for his own account at any time.

Here, the receipt of the membership interest is compensation characterized and taxed as ordinary personal income received for time and effort spent rendering services as an agent of the LLC.

Contributions of services to the LLC in exchange for a membership interest are not tax-free transactions. Compensation for services does not receive the same tax-exempt treatment given the exchange of a syndicator's **contract rights** for a share ownership in the LLC. [IRC §721]

The *cash value* of the LLC membership interest received by the syndicator in exchange for the brokerage and organizational (promotional) services he renders on behalf of the LLC (or the seller as a listing agent) is reported to the Internal Revenue Service (IRS) and the Franchise Tax Board (FTB) as part of the syndicator's brokerage business income. [IRS 1040 Schedule C]

The dollar figure given the membership interest the syndicator receives for his services is the amount he receives as his fee. However, for tax purposes, he reports as his business income from his services the *cash-equivalent value* of the membership interest he receives, not the dollar figure he sets as his contribution.

The **cash-equivalent value** of the membership interest the syndicator receives for his services is taxable in the year received, unless it is *subordinated* to cash investors. To be classified as subordinated, the syndicator's membership interest must be so lacking in **parity** with the interests held by the cash investors that its cash value is entirely speculative. Thus, his membership interest cannot be determined to have a present value other than zero.

When the syndicator receives an *unsubordinated* interest in the LLC, he is on a parity basis with the cash investors. An **unsubordinated** membership interest received for promotional and organizational services is treated as equivalent to the syndicator's receipt of cash. Thus, the dollar amount set for the syndicator's parity co-ownership interest will be taxable in the year he receives his co-ownership interest, and reported as ordinary income for his professional services at the dollar figure placed on his membership interest.

However, a Class B subordinated interest received by the syndicator in exchange for services rendered has no present value. Subordination limits his membership participation to **future income and profits** that may be generated by the property acquired by the LLC. The cash investors holding Class A membership interests receive a **priority return** of their capital investment. They share first in the income and profits before distributions of any remaining income or profits to a Class B member, i.e., the syndicator.

The taxable value of his services will not be established until the syndicator sells his interest or the property is sold and his interest liquidated. [**Campbell** v. **Commissioner of Internal Revenue** (1991) 943 F2d 815]

For example, a syndicator receives a subordinated Class B membership interest in the LLC in exchange for services he rendered acquiring property as the manager of the LLC. The membership interest the syndicator receives in the LLC need not be reported and taxed until he receives funds on a resale or refinance of the property, or he sells his subordinated interest.

The syndicator's services are not taxed when he initially receives a **subordinated interest** in the LLC, even though the share of ownership he receives represents ordinary income for services he rendered on behalf of the LLC to locate and acquire property. [**Vestal** v. **United States** (1974) 498 F2d 487]

In a related example, a syndicator receives a subordinated interest in the LLC in exchange for his promotional or organizational time and effort. Later, before the LLC sells the property, the syndicator sells his interest.

On the transfer of his subordinated interest, his time and effort — services previously rendered but not previously reported and taxed — are given cash value equal to the dollar amount he received for transferring his ownership interest in the LLC. The cash received on his sale of the fractional interest he received for services is taxed at ordinary income rates since no prior value was reported and taxed to convert it to capital under §83. [**Diamond** v. **Commissioner of Internal Revenue** (1974) 492 F2d 286; IRC §83]

Editor's note — While the Vestal *and* Diamond *cases relate to limited partnerships, the treatment is fully applicable to LLCs. LLCs automatically qualify with the Internal Revenue Service (IRS) for partnership reporting. [IRC §7701(a)(2)]*

For either a pre-existing LLC or a yet-to-be-created LLC, the alternative to the contribution of time and effort performing brokerage services is the exchange of property rights, created or controlled by the syndicator in his name, for an ownership interest in the LLC.

Converting services to capital

The subordinated ownership interest received by a syndicator for his services has no ascertainable cash value at the time of closing. Thus, his earnings for the services rendered are not taxed at the time of closing since what he received as compensation has a value of zero. However, when the property or the syndicator's Class B interest is sold, the money he receives is then taxed at ordinary income rates for services he previously rendered.

This adverse taxation at **ordinary income rates** can be avoided if, at the time the ownership interest was received, an *election* was made to convert it to capital from its income-for-services status.

The syndicator may elect to place a value, albeit small and certainly only a fraction of the value placed on his Class B contribution, on the ownership interest he receives for his services and report it as earnings received. He will then pay the income tax due on the declared earnings as his business income.

The value he gives the ownership interest as the amount received and reported for his services under the election becomes the *cost basis* for his ownership interest. When the interest is liquidated by a sale of the interest or the property, the price received is reported as the sale of a capital asset at a profit — the cost basis having been set by the income election valuation. Thus, capital gains rates apply to the sale, not ordinary income rates.

To accomplish the election, an §83(b) Election Statement is filed with the IRS within 30 days after the close of escrow on the purchase of the syndicated property (and receipt of the Class B subordinated ownership in exchange for services instead of an assignment of property rights). Another copy is addressed to the LLC since it issued the Class B interest for the services. A copy is also later attached to the syndicator's 1040 tax return for the year.

The §83(b) Election Statement describes the interest received, the terms of the subordination (restrictions), the value placed on it for the election (even though the interest has no present cash value) and any amount paid for the interest (such as including the value of the property right assigned together with the services). [IRC §83(b)]

Exchange of both services and rights

To further clarify his intentions to create and assign property rights, a syndicator will:

- contribute his purchase rights to acquire property in exchange for a membership interest in the LLC; and
- render services for the promotion and formation of the LLC that the LLC will pay for in cash.

Services rendered include the time and effort spent forming the LLC and soliciting investors to provide equity financing for the acquisition of property. Conversely, **property rights** held in the name of the syndicator, embodied in the purchase agreement or option to purchase the property, are assigned to the

LLC for a membership interest. The property rights exist as a capital interest even when his sole purpose in contracting to buy the real estate is to syndicate the equity financing and assign his purchase rights prior to closing escrow. No holding period exists in tax-free exchanges.

Exclusive of contracting to buy property, the task of syndication — forming the group investment — includes originating the LLC entity, creating the investment circular, soliciting investors and gathering their funds. These efforts are on behalf of the LLC, not part of the negotiations with the seller and investigations into the property's conditions. Arguably, the syndicator is selling shares in an LLC which he created and owns, constituting a short-term capital gain or inventory of his business, both taxed at ordinary rates but with an additional self-employed tax (15.3%) on the business earnings.

An all-services tax challenge (or an arbitrary partial allocation) by the IRS arising out of the syndicator's exclusive use of the Internal Revenue Code (IRC) §721 tax exemption to report all of his front-end earnings in a syndicated transaction can be avoided. To do so, the syndicator needs to separate his contract rights from his compensation for services and evaluate them individually. To establish the value of each before closing, a syndicator should:

- receive a cash fee for his organizational services, reported and taxed in the year the LLC acquires the property; and

- assign his purchase rights to the LLC for a membership interest, an exchange that is a tax-exempt transfer of his contract rights.

Consider a syndicator-developer who has maps, engineering and plans prepared for a property he now has under contract as the buyer. To close escrow and take title to the property, the syndicator forms an LLC to equity finance the acquisition. He contributes the subdivision plans to the LLC for a membership interest in the LLC.

Here, the plans are considered **property** he produced for himself, not the product of **services** rendered on behalf of someone else. The value created by the development of maps, engineering and plans the syndicator contracted for and owns in his name is not taxed when assigned to the LLC.

In addition to creating the real estate maps and plans in his own name when acting as a principal for his own account, the syndicator performs services on behalf of the LLC: he prepares the investment circular, forms the LLC and solicits investors. The syndicator is compensated for these organizational services in cash. Thus, the value of the services — cash — will be reported as business category income in the year received. [**United States** v. **Frazell** (1964) 335 F2d 487]

By delivering to the LLC services and property rights, and setting the value of each in agreements prior to closing, the syndicator's receipt of cash for his services greatly reduces the risk of losing a portion of the IRC §721 tax-exempt treatment allowed on the transfer of his contract right to acquire real estate in exchange for a membership interest in the LLC.

Self-employment taxes

In addition to paying income tax, the syndicator will pay 15.3% self-employment taxes on the income he receives for services rendered forming the investment group and the LLC. Self-employment taxes are imposed on the net income produced by the syndicator in his **trade or business**, namely, on monies paid to the syndicator less expenses for forming and funding the LLC and for his ongoing property management services. [26 Code of Federal Regulations §1.1402(a)-1]

The share of spendable income he receives on a distribution to all members — including himself — is **rental income**. The self-employment tax is not imposed on earnings generated for members by the operation of the LLC's real estate. Rental income is passive category income, not trade or business category income. [26 CFR §1.1402(a)-4]

The ownership and operation of a rental property is **not a business**, even though the ownership is structured as an LLC, which is a business entity.

Members are not liable for self-employment tax on rental income since the LLC has no trade or business income — unless it owns land which it holds for development in a resale program (dealer property).

Also, the self-employment tax is imposed on the income of the owner-operator of a hotel, motel or vacation rental, since the average occupancy is for a period of **30 days or less** and thus, as does dealer property, constitutes business category income for material participants. [26 CFR §1.1402(a)-4(c)]

In contrast, the earnings generated by the owner-operator of income-producing real estate are reported as rental income or losses in the *passive income category* if the average occupancy of all tenants is more than 30 days.

Accordingly, the manager escapes the self-employment tax for any distributions based on his pro rata ownership interest acquired in the LLC for services rendered. However, the manager's income for services rendered under a **property management contract** with the LLC or its members is considered trade or business income subject to the self-employment tax.

Chapter 12 — Tax benefits for co-owners

This chapter applies income tax reporting rules to the co-owners' capital investment and their share of operating income or losses during ownership.

Capital recovery, operating income, losses

The relief from income taxes provided for owners of real estate is merely an incidental source of earnings. The incentive of tax relief is minor in amount and least in importance when compared to earnings generated by the property, including:

- spendable income;
- loan reduction; and
- growth in property value.

An investment analysis based on a property's fundamentals historically used to set its market value does not include the income tax consequences of its ownership. Income tax consequences of ownership do not impact the analysis of a property. The taxes a co-owner pays depend on the tax status of the co-owner, not the property, except for the duration of depreciation schedules.

The major income tax benefit derived by an owner of improved real estate is the annual **tax-free return** of a portion of his invested capital, called a *depreciation deduction allowance*. The deduction provides an accounting method for the recovery of the owner's invested capital — the cash down payment and funds from a purchase-assist loan or debt assumed — without incurring a tax when the capital is returned.

In theory, the return of capital recovered tax-free from the property's rental income is justified since the recovery of the annual loss in value of the improvements due to deterioration, obsolescence and wear brings an improvement to a statistical useful end after a period of 27.5 to 40 years. However, the experience of ownership in most of California demonstrates that well-maintained property actually increases in value over time, a value tracking the growth of the local population and increase in its wealth. Thus, the annual tax-free recovery of capital from rents is a windfall for most property located in California.

The tax-free return of capital is the result of the annual depreciation allowance an investor is permitted to write off based on the cost of improvements acquired as part of the real estate. The annual amount of depreciation is deducted from the property's net operating income (NOI) before arriving at the amount of the rental income that is reported and subject to income taxes.

The rental income sheltered by the depreciation allowance is often calculated for investors over the initial ten-year period of ownership, as an annual yield on their cash contributions. Technically, the amount sheltered from taxes by the depreciation deduction is not a **return on** the capital invested (from rental income), but a **return of** the invested capital (originally contributed).

Consider an income-producing property with an annual gross operating income of $120,000 and operating expenses of $40,000. The property's NOI is the difference, $80,000.

To determine the annual reportable operating income or loss for the ownership of the property, the interest paid on loans and the depreciation allowance are deducted from the NOI. *Interest* is the cost of borrowing additional capital to fund the purchase of the investment. *Depreciation* is the owner's recovery of all of his invested capital allocated to improvements. [See **first tuesday** Form 352]

Suppose the annual interest payments amount to $60,000, and the depreciation deduction is $20,000. Thus, the property has no reportable operating income (or loss), since the total amount of interest paid and depreciation deductions ($80,000) equals or exceeds the NOI ($80,000).

In a separate analysis, the NOI includes *spendable income*, the title given to the amount of rents remaining after deducting the loan payments of principal and interest from the NOI. Here, principal and interest payments amount to $67,000 annually, which is paid out of the $80,000 NOI. The remaining $13,000 is spendable income that is distributable to the co-owners.

Thus, depreciation is not a factor when determining the amount of spendable income a property produces, since it is not an expense. Taxwise for the owner, spendable income comprises ordinary income, a return of capital or a mix of both, depending on the size of the depreciation deduction and the amount of the principal reduction on loans, neither of which relate to operating the property.

Here, the property does not produce reportable income, but does generate spendable income. Since the owners borrow capital to buy the property, no part of the spendable income is taxed in the first year of ownership. The amount of spendable income (and loan reduction through the payment of principal) is "sheltered" by the depreciation deduction. Technically, the spendable income becomes classified as a tax-free return of invested capital, not as income or profit.

However, rents sheltered by depreciation deductions are often casually viewed as an additional source of income for the investors — as though it were a yield on the original investment — even though rental income, to the extent it is offset by depreciation, is a **return of capital**, not a yield at all.

The rationale that allows the return of capital to be viewed as income is that real estate market values are not perceived to be negatively affected by the deterioration and wear of improvements. This dismissal of an improvement's aging seems justified due to the offsetting effect on value brought about by inflation, appreciation, maintenance and proper management of income and expenses.

Losses offset income in three ways

For each limited liability company (LLC) co-owner, a rental property's reportable losses from annual operations are first applied to offset any reportable income the co-owner may have from other rental properties and passive business investments. Both sources of income are reported in the *passive income category* on Schedule E of each owner's 1040 tax return.

However, rental **operating losses** (including the allowance for depreciation) greater than the co-owner's income from all passive-income category investments do not then disappear. The annual operating losses from the property are reported by each co-owner on his 1040 return to offset income and profits within other categories.

Depending on the co-owner's level of involvement in management, his adjusted gross income and whether the LLC files a return, he can offset his income from other categories in one of the following ways:

1. If the co-owner qualifies as being in a *real estate related business* and further qualifies as a *material participant* in the management of this property, the amount of the loss on Schedule E **lowers** the amount of the co-owner's adjusted gross income (AGI).

2. If the co-owner qualifies as *active management*, the amount reported as the loss on Schedule E is **deducted from** the co-owner's AGI to determine his taxable income, called the *$25,000 rental loss deduction*.

3. If the co-owner does not qualify for the adjustment to AGI or the rental loss deduction, the amount of the loss on Schedule K-1 or E is carried forward by the co-owner for use in future years to offset income or profits from the property incurring the loss, called *suspended losses*.

Services rendered as a material participant

For a co-owner to qualify to write off his share of the property's operating loss (in the passive income category) offsetting his income from trade or business category or portfolio category income and **reduce his AGI**, he must be classified as a *material participant* by rendering services in real estate related business activities.

Businesses in which a co-owner might be involved in rendering real estate related services include:

- the acquisition, development or construction of real estate;
- the management of income properties in which he owns an interest (as a landlord); and
- any real estate brokerage services performed on behalf of others as a real estate licensee.

When a co-owner is involved in real estate related businesses and intends to write off his rental operating losses by reducing his AGI, he must also qualify as a *material participant* in those businesses by:

- spending at least 750 hours per year rendering real estate related services; and
- providing real estate services for more than half of all his time spent rendering services of all types, including other types of professional, business or investment services.

The syndicator acting as both the manager and a co-owner will most likely qualify as a material participant in real estate related businesses since he will probably render no other type of service than real estate related, such as acquisition, management and sales of real estate, for himself or for others in this and other properties.

As for the other co-owners, they will need to be involved in real estate businesses other than their investment in the syndicated property in order to qualify to write off this property's operating loss against sources of income other than passive business opportunity investments and rental properties and reduce the AGI.

The $25,000 rental loss deduction

Consider a co-owner who does not qualify as a material participant in real estate related businesses. He cannot directly offset income from other categories and reduce his AGI by the amount of his share of the operating loss. Here, he may qualify to **deduct** the operating loss from the AGI (instead of reduce the AGI), called the *$25,000 rental loss deduction*. To do so, the co-owner must be *actively involved* as an owner who authorizes the syndicator to act as the property management under contract to the co-owner.

For a co-owner to avoid automatic disqualification as an **inactive co-owner**, the LLC or tenant-in-common (TIC) vesting cannot file a partnership return. Thus, the co-owner will not receive or file a K-1

Schedule with his 1040 tax return. It is the K-1 that identifies a co-owner as an inactive co-owner of the real estate. Instead, he will file a Schedule E with his 1040 tax return to report his share of the operating loss. [Internal Revenue Code §469(i)(6)(C)]

An LLC can avoid filing a partnership return with the IRS under the small partnership exemption when ten-or-less co-owners (husband and wife are counted as one) are involved or the co-owners are TIC co-owners and number no more than 35. [See Chapter 15]

Several limitations are placed on an LLC co-owner's use of the operating loss under the **$25,000 rental loss deduction**, including:

1. The co-owner's fractional ownership interest must make up a minimum of 10% of all interests in the LLC. [IRC §469(i)(6)(A)]

2. The co-owner cannot report a rental loss above $25,000.

3. For each dollar the co-owner's AGI exceeds $100,000, there must be a 50% reduction in every dollar of the deductible operating loss amount, which eliminates any deduction of a rental operating loss if the co-owner's AGI exceeds $150,000. [IRC §469(i)(3)]

4. A co-owner must personally enter into the property management agreement (with the other co-owners) which employs, for a period not in excess of one year, a property manager to enter into leases with tenants. The LLC's operating agreement must also state the LLC's purpose is to hold title on behalf of the co-owners, all of whom are classified as TIC co-owners, and operate the property in the name of the property manager, not the LLC.

When a co-owner is unable to use the operating loss under the $25,000 rental loss deduction (or as a real estate related business), the losses are retained on the co-owner's books as *suspended losses.* Suspended loss is carried forward to be used in future years when reportable operating income is generated by the property or a profit is taken on a sale of the property.

Chapter 13 — Tenants in common or tax partners

This chapter presents the arrangements an owner of a fractional interest in a real estate investment must undertake to qualify his separate sale or purchase of that individual co-ownership interest as §1031 property.

§1031 fractional ownerships

For the profit taken on the sale (or exchange) of an ownership interest in real estate to be exempt from taxes under Internal Revenue Code (IRC) §1031, the interest sold must be an **ownership in property** that qualifies as *like-kind property*, commonly called §1031 property. Following in tandem, the ownership interest acquired in the replacement real estate must be §1031 property.

Thus, in any §1031 reinvestment plan, both "legs" of the plan — the property sold and the property acquired — must qualify as the investor's **ownership** of §1031 property. §1031 property is initially classified as property held either for **investment** or **productive use** in a business. [Internal Revenue Code §1031]

When an entity such as a partnership or limited liability company (LLC) sells a parcel of real estate held either for investment or productive use and replaces it by purchasing another parcel it will hold for investment or productive use, the entity has completed a §1031 tax-exempt transaction. The co-owners of the partnership or LLC then separately report their pro rata share of the gain passed through to them on the §1031 transaction as exempt from taxes — *non-recognition* of profits. The group moved the owners from one property to another as an entity — selling and buying as one *person*.

However, an investor's fractional ownership interest in a group does not qualify as §1031 property if the interest is a **co-ownership interest** in an entity, such as an limited partnership (LP), LLC, corporation or other co-ownership (such as a tenancy in common) arrangement calling for the alienation of the property or fractional interest by less than unanimous consent. It is the entity that owns the real estate.

An investor's sale of his percentage of co-ownership in the entity, independent of the sale of the real estate by the group, does not qualify for the §1031 exemption. The individual co-owner's reinvestment plan includes the sale or purchase of a fractional ownership interest in an entity classified as a *tax partnership*.

Further, a co-owner vested as a tenant in common (TIC) with a group of co-owners is considered a *tax partner* in the co-ownership of §1031 property if he has **agreed to restraints** on his common law rights as a tenant in common to freely manage his interest in the property, independent of control by other co-owners and as he sees fit.

Once classified as a **tax partner** for income tax reporting, the TIC investor is considered a co-owner of an interest in a *tax partnership*, not a co-owner holding an ownership interest directly in the real estate (even though title is vested in his name with others). As a result, and for tax purposes only, the tax partnership is treated as the sole owner of the §1031 property. The TIC co-owners are partners who merely own a personal property interest in the partnership, not the real estate.

When a TIC co-owner, by agreement or by definition, is a *tax partner* with others, none of the profit taken on the separate sale of his fractional interest qualifies as exempt from taxes. To avoid being a tax partner on the sale or purchase of a fractional interest in a group which presently owns §1031 real estate, the fractional interest sold or acquired must be shown to be an **independently manageable** ownership interest held directly in the real estate, not the investor's mere ownership of an interest in a TIC partnership. A partnership operates separate from each TIC and it is the partnership that **controls the ownership rights** in the real estate for all co-owners.

A tax partnership vs. a California partnership

The **coordinated conduct** of co-owners in the exercise of *ownership rights* to operate the investment real estate they co-own is viewed differently under federal income tax law than under California partnership law.

Basically, if co-owners **share** the income, profit and losses generated by a joint investment in real estate and operate under an unincorporated ownership arrangement, California partnership law (which broadly defines a partnership) classifies the profit-sharing group as a partnership. Thus, California imposes *agency obligations* on each co-owner to act in concert for the mutual benefit of the group from the first moment of discussions about a syndicated investment. Thus, anarchy within the group of co-owners is legally avoided as public policy in California.

Conversely, federal tax law places emphasis on TIC law to establish co-owner rights. TIC ownership does not rise to tax partner status unless the co-owners are operating as either:

- a declared partnership;
- an LLC; or
- a cooperating TIC.

To avoid federal tax partnership status, each co-owner vested as a TIC must have the unrestricted common law right to independently *alienate* his fractional interest without the prior consent of other co-owners. Further, each co-owner must also have the unrestricted right to independently block any *alienation* of the entire property co-owned by the group.

Alienation of the entire property refers to its sale, further encumbrance or lease for a period exceeding one year.

Taxwise, the ownership of a TIC interest that retains its common law right of alienation in real estate is viewed as being the ownership of a fractional interest in the real estate itself. Thus, the TIC is not the owner of an interest in a partnership, but actually owns the property.

Further, TIC co-ownership arrangements may provide for **cooperation among the co-owners** in the ongoing management and operation of the property. Operating the property by *centralized management* does not violate the requirement of unanimous approval for the alienation of property. Thus, the alienation rights inherent in ownership are distinguished from the day-to-day operations of the property.

An understanding of the distinctions between federal tax law, which defines §1031 property investments as excluding fractional interests held by *tax partners*, and California's partnership law, which controls joint ventures and profit sharing ownerships, is helpful to all individuals involved in investment groups, such as:

- **syndicators** structuring the ownership for acquisition of property by an investment group they are forming;

- **investors** acquiring or withdrawing a fractional interest from a syndicated real estate investment; and

- **brokers** (or other advisors) representing a person who is buying into or withdrawing from a syndicated real estate investment.

Knowing the parameters for activities that establish a partner under California partnership law versus activities that establish a tax partnership for federal income tax reporting avoids unintended and unexpected results under either set of laws, or worse, the loss of a transaction because of insufficient knowledge.

Accordingly, this chapter contains an analysis and application of the overlapping partnership laws controlling the syndication of real estate investments (state law) and the exemption of profits from taxes (federal law) on a sale or purchase of a fractional interest in a syndicated investment with §1031 money.

We cooperate in California

A group of investors acquire income-producing property located in California. Title is taken as TICs, naming each investor and stating his percentage or fractional share of undivided ownership in the property.

The property is occupied by tenants under short-term leases and periodic rental agreements that provide for the landlord to care for and maintain the premises.

The co-owners orally agree:

- to divide annual operating income (or losses) and resale profits pro rata based on their percentage of ownership;

- to hire the broker who organized the group to manage the property with authority to locate tenants, enter into short-term lease and rental agreements, collect rents, contract for the repair, maintenance, utilities and security to be provided by the landlord under the lease agreements, pay operating expenses and mortgage payments and distribute spendable income to the co-owners quarterly;

- to grant each other a right of first refusal on a resale of their fractional TIC interest; and

- to grant the syndicator the option to purchase the property at its fair market value.

Are the co-owners conducting themselves as partners under California partnership law despite the TIC vesting placing each co-owner on title?

Yes! Co-owners of California real estate vested as TICs, when engaged in the business of jointly operating the property on terms calling for them to share income and profits, are conducting themselves as partners. Thus, they are considered agents of one another, charged as fiduciaries with the duty to cooperate in the ownership of the property. [Calif. Corporations Code §§16202(a), 16202(c)(3)]

A TIC vesting does not control the possessory rights of the co-owners when the co-ownership in fact constitutes a state law partnership. For example, a partner may use or possess partnership property only on behalf of the partnership, while a TIC co-owner (at common law) may use, possess or lease the property himself, without regard to any other co-owner. [Corp C §16401(g)]

Further, TIC co-owners who conduct themselves as joint operators of a property, such as occurs with a rental property, are not co-owners of the real estate. They are partners who co-own their partnership. Thus, the partnership owns the property without concern for the type of vesting the group of investors has chosen.

As a partner, the vested co-owner does not hold a right to an interest in the property that he can independently possess or separately transfer by leasing the property to a tenant without concern for the other co-owners.

The only transferable interest the TIC owns is his fractional interest in the partnership. The partnership interest entitles him to share profits and receive distributions. Thus, the co-owner's fractional interest, vested as a TIC interest, is no more than a personal property share of ownership in a California partnership. [Corp C §16502]

Trustees for one another, by law

Although title to an income-producing property held by co-owners for profit is vested in the names of all the co-owners, each co-owner actually holds title as a trustee on behalf of all the TIC co-owners, collectively called a partnership. [Calif. Civil Code §682; Corp C §16404(b)(1)]

As co-owners and operators of a rental property, they have formed a partnership, holding title in the most troublesome of all California co-ownership vestings: a TIC.

Thus, the conveyance of a co-owner's TIC interest to another person conveys nothing more than the co-owner's interest in the partnership's equitable ownership of the property. The partnership's title to the property is held in trust, in the name of each co-owner for the benefit of all co- owners.

The defining acts of partners

Prior to California's 1949 enactment creating tenancies in partnership, TICs that owned rental property requiring centralized management did not constitute a partnership. Before 1949, no agency relationship existed between TIC co-owners to protect the common interests of the co-owners to share profits. The federal tax law defining TIC interests remains the same today as the prior California law controlling TICs. [**Johnston** v. **Kitchin** (1928) 203 C 766]

Since 1949, a California partnership exists when two or more investors join together to carry on a business for income and profit in California. A California business includes every trade, occupation or profession. [Corp C §16101(1)]

While landlording is not a trade or business category activity for federal income tax purposes (since the property is a passive rental operation or a portfolio asset), landlording by a syndicated group is an occupation under California partnership law. A co-ownership is a California partnership if the co-owners are involved in sharing earnings and profits from rental operations, refinancing and resale of the property they own. [Corp C §§16202(a), 16202(c)(3)]

Also, the receipt of income (from operations) and profits (from a sale) by co-owners from their joint investment is considered evidence of a California partnership, unless the earnings are received by a co-owner in payment:

- of an installment note, including one given in consideration for the sale of goodwill or property;
- for wages or rent due the co-owner;
- on an annuity to a surviving spouse, representative or deceased co-owner; or
- as interest on a loan. [Corp C §16202(c)(3)]

The TIC partnership

With a TIC vesting, the sharing of income and profits earned by each co-owner's separate use of the property — such as occurs with the extraction of minerals from the property by each co-owner for their own separate use — does not in itself create a California partnership. It takes more than the sharing of use and possession by co-owners to constitute conduct on the level of a partnership. [Corp C §16202(c)(1)]

It is the interaction and coordinated conduct of the co-owners while directly or indirectly managing or operating the investment that determines whether a state law partnership relationship exists between them. Once the conduct of co-owners in a coordinated ongoing operation of the property constitutes a joint and mutually beneficial activity, an agency relationship exists between the co-owners.

With the agency relationship comes fiduciary duties owed to partners, which obligates each prospective or actual co-owner to act in the best interest of the group, not to act independently on the investment opportunity before them. [Corp C §16404; **Leff** v. **Gunter** (1983) 33 C3d 508]

Thus, co-owners of rental property who are vested as TICs and who act collectively to manage the property or authorize a property manager to operate the property on their behalf, hold ownership to the real estate under what has been best entitled a tenancy in partnership. Each co-owner is a tenant in partnership with all other co-owners.

By the sharing of income among co-owners who are vested as TICs, a tenancy-in-common partnership is established. Each co-owner is subjected to the rights and obligations of a partner, such as:

- the duty to hold title to the real estate as a trustee for the benefit of the partnership [Corp C §16404(b)(1)];
- the right of each co-owner to use and possess the real estate — but only for group purposes [Corp C §16401(g)];
- nontransferability of the right to use and possess the real estate, unless all co-owners collectively transfer the partnership's right to possession of the property [Corp C §§16203, 16501]; and
- acknowledgement that the property co-owned by the group is not subject to attachment or execution on a judgment against an individual co-owner, only on claims against the partnership. [Corp C §§16201, 16501]

Even when co-owners do not characterize their mutual working relationship in a profit-sharing investment as a partnership, they are still obligated to act on behalf of the group as though they were partners in a partnership. [Corp C §16202(a)]

Under state law, TIC co-owners hold no interest in the real estate they co-own that they can legally transfer, voluntarily or involuntarily, independent of the rights of the resulting California partnership. [Corp C §16502]

However, federal tax law for determining the tax partner status of TICs disregards state laws to the contrary. [Revenue Procedure 2002-22]

A tax partner's profits disqualified

The penalty for a TIC co-owner who is federally classified as a tax partner in the ownership of either the property sold or the property acquired in a §1031 reinvestment plan is the loss of the entire §1031 tax exemption for profit taken on the property sold.

Thus, the arrangements or activities a co-owner, other co-owners, a property manager, syndicator or lender agree to between themselves which would make them co-owners and tax partners, are of great concern to investors in syndicated real estate investments programs.

When a co-owner of investment real estate is classified by the Internal Revenue Service (IRS) as a partner, the real estate is considered to be owned by a tax partnership. Classified as a partner, the co-owner's ownership interest is that of a share in a partnership and the share does not qualify as §1031 property.

To avoid tax partner status, a co-owner in a real estate investment does not want to be financially coupled with a co-owner or manager who provides the tenants with services that are unrelated to the operation of the property, such as linen service, maid service, meals, etc.

Thus, an investor with after-tax cash he has accumulated or §1031 money to reinvest who makes a capital contribution to a group being formed to jointly own and operate an income-producing parcel of real estate must be assured no co-owner is sharing in any income from tenants other than rent. Co-owners who occasionally provide tenants with business or professional services for a fee separate from rent, or share in the income received by others providing services to tenants that go beyond the customary services required under a lease, establish tax partner status.

Co-owners or partners

Tax partner status is of no concern to a co-owner, unless and until the co-owner:

- withdraws from a group to separately invest on his own; or
- desires to exchange his sole ownership in real estate (or the cash from its sale) for a fractional ownership in a replacement property.

To understand the **federal distinction** between a co-owner's non-partner status and tax partner status in the co-ownership of an investment in real estate, it is instructive to know the purposes behind the different income categories. Each category has been established to report and account for income, profits and losses from the ownership and sale of real estate, put to different uses by the owner.

Three income categories have been established for reporting income. The source or nature of the income, profit or loss determines the income category in which the income, profit or loss will be reported, such as:

- *trade or business income category*, which includes real estate occupied and used by the property owner for a business he owns and operates, including residential housing with an average occupancy of less than 30 days, such as motels, hotels, vacation rentals, and other transient housing and boarding facilities that provide occupants with services unrelated to the care and maintenance of the property;

- *passive income category*, which includes residential and nonresidential rental properties with an average occupancy of 30 days or more, but with a tenancy less than a triple net (master or ground) lease, during which the owners provide the tenant with the repair, maintenance, security, utilities and management of the property typically provided or required by state law in exchange for rent; and

- *portfolio income category*, which includes income-producing real estate subject to long-term lease agreements which shift the responsibility for the care, maintenance, repair and operation of the property and the payment of expenses of ownership such as property taxes, assessments and insurance premiums to the tenant (as in a master lease, ground lease or other type of management-free triple-net lease), and includes other like-type flows of management-free income such as bonds, stocks, interest on loans (trust deed investments) and vacant, unimproved real estate held for profit on a resale (not as dealer property).

Thus, income-producing real estate *held for investment* and leased to tenants is classified as either:

- rental (passive income) property requiring **management services** related to the tenancies; or

- portfolio income property requiring no **tenant-related services** to be provided by management.

Land held for investment that does not require any management services, except for the annual payment of taxes, assessments, insurance premiums and the like, is classified as portfolio property. However, land held for development, subdivision and resale by the owner or a co-owner is trade or business category inventory.

Stated another way, rental (passive income) property and portfolio income property are not business property. On the other hand, a motel or hotel is a business property since services unrelated to rental property operations are provided.

And as a further distinction, the co-ownership arrangements relating to the management of rental or portfolio properties consists of services customarily provided for tenants by a landlord directly, or through an agent. The **landlord's services** provided for tenants are not business-related services, such as maid services, food, laundry pickup and delivery, towels or linens, which are provided to more transient occupants of trade or business category property, such as hotels, motels, transient housing or vacation rentals.

Thus, negotiations with prospective tenants to lease units or space within the property, limited to providing customary landlord services, such as the collection of rent, evictions, repairs and maintenance of the property, utilities, security and other real estate related services typically included in the rent, is not a business. Obviously, the property is not a business income category asset which provides **business-related service**, as an operator of a hotel, motel, boarding house or vacation rental property does.

Without being coupled to a business service, the capital contribution of a co-owner and landlord services the co-owner provides in the form of rental property operations for the care and operation of the property as a rental or portfolio asset, do not make the co-owner a tax partner. None of the co-owners are involved rendering *additional services* to the tenants through a business, enterprise or joint venture in which one or more of the co-owners share profits or losses in trade or business services offered to tenants.

A property manager and his authority

Co-owners can join together to own and operate income-producing property and will not be considered tax partners when they hire a broker (who may be a co-owner) as an independent property manager. The manager may be given all the authority he needs to do all acts necessary to provide services for tenants which are customary under regular leasing arrangements.

However, the manager may not be given the authority to enter into long-term leases (more than one year), sell or encumber the property. These are the rights of *alienation* held by each co-owner which must remain unrestrained and require unanimous approval by all co-owners to be exercised.

The authority co-owners may give a property manager without becoming tax partners is extensive, and includes the authority to:

- act on behalf of the co-owners to negotiate and enter into leases and rental agreements with prospective or current tenants;

- collect deposits, rents and other amounts due from tenants and deposit them into a common bank account maintained for (but not in the name of) the co-owners;

- contract for all services customarily provided to tenants under similar circumstances as part of the rent, including normal repair and maintenance of the property, utilities, garbage/trash pickup, a resident manager and security;

- pay from rents (and additional funding by co-owners made necessary due to insufficient rental income) the charges for all services the manager contracts for as authorized, including the payment of property taxes, assessments, insurance premiums, mortgage payments and management fees;

- at least every quarter, disburse to the co-owners their share of spendable income; and

- prepare annual statements for each co-owner setting forth his share of income, expenses, interest and depreciation. [IRS Revenue Ruling 75-374]

Thus, co-owners are merely limited to the classic relationship between a property manager and an owner of income-producing property. No co-owner, directly or indirectly through another person, will carry on or share profits in a trade or business which will provide additional services to the tenants beyond those customarily provided under common leasing arrangements in exchange for rent.

However, each co-owner will be considered a tax partner who is carrying on a trade, business, financial operation or venture in a tax partnership if:

- he renders the additional **business-related service** to tenants; or

- the property manager renders the additional business services and one or more co-owners (including the co-owner manager) **share in the income** the manager receives for providing the business-related service to the tenant.

Thus, the **tax partnership** includes the person rendering the business-related services whose income for those services provided is shared with one or more of the co-owners of the real estate. It does not matter that the person rendering the services (such as the property manager) may have no claim to the spendable income from the rental operation, proceeds from a refinance or net proceeds from its resale.

The property manager hired by the co-owners may not be a tenant and must be on a short-term management agreement not to exceed one year. The management agreement may only be extended or renewed for a period not to exceed one year, and only by a unanimous vote of the co-owners (or by a failure to vote). The property manager's pay must be comparable to fees paid brokers in the area for managing similar properties and providing similar real estate related management services.

While the manager may not be a tenant, a long-term lease, pre-existing or unanimously agreed to by all the co-owners, could provide for a **lessee** to care for, operate and incur at his expense all the typical services (sub-)tenants may need to occupy the premises, including the right to sublet the property, an arrangement called a *master lease*.

Also, the property manager may be granted an option to purchase the property. However, the price to be paid for the property on exercise of the option must be set as the **fair market value** of the property at the time of purchase.

The devolution of TIC control

Some flexibility exists regarding the annual unanimous consent of the TIC co-owners to renew property management agreements and the extent of authority they may grant management to enter into long-term leases of portions of the property. [IRS Private Letter Ruling 2005-13010]

Each long-term lease must be unanimously approved by all TIC co-owners to qualify each individually owned fractional ownership interest as §1031 property. This unanimous approval is satisfied by an **annual unanimous approval** of a set of long-term leasing guidelines for management. Management would then follow the guidelines in the exercise of the leasing authority unanimously given by the property management agreement.

Thus, the authority given in the leasing guidelines is viewed as a method by which each TIC co-owner retains direct control over his right to disapprove and bar entry into a proposed lease. The parameters set in the guidelines place a limit on management's flexibility in the discretionary leasing of the property.

The IRS example for leasing guidelines include the typical standards any landlord sets for qualifying prospective tenants and structuring the terms and conditions of lease provisions. Guidelines for leasing include the tenant's and landlord's obligation to care for and maintain the property, selection of the type of tenants, tenant creditworthiness, a range of rent amounts to charge tenants, the term of the lease and the content of lease provisions.

Interestingly, the syndicator managing the property is allowed, as outlined in the IRS letter ruling, to bar any TIC co-owner from altering the guidelines during the year following their approval since the unilateral change would be less than unanimous approval. Until the next annual approval of leasing guidelines

occurs, each TIC co-owner agrees not to alter the guidelines by exercising his ownership rights to lease the property, himself or through a competitive leasing agent, on conflicting, and possibly more advantageous long-term arrangements. [PLR 2005-13010]

Also, while the requirement for unanimous annual approval of the property management agreement is an anarchic condition detrimental to current management, apparently automatic one-year approval by **mere silence** at the time of the annual renewal is deemed a sufficient exercise of a TIC co-owner's right to approve or disapprove the renewal of an annual contract with management.

For example, a TIC operating agreement entered into by all TIC co-owners calls for **automatic annual renewal** of the property management agreement. Should all TIC co-owners **fail to object** to any provisions submitted by the management team in a *notice of renewal* of the management agreement, management is approved for another year — by silence. Thus, a TIC co-owner exercises his right to control his interest in the property by objecting to the renewal. However, if he does object he will be penalized.

The conduct of management permitted in the letter ruling gives co-owners who agree with management the right to buy out the objecting co-owner's interest. If not bought out, the objecting co-owner is limited to hiring his own property manager. However, for doing so, he will alone bear the cost of the manager he hires. Further, his manager will only be an advisor to the current management, unable to exercise any objection he or his employing co-owner may have. Could management have it any better? You bet they can!

As a final detriment for objections to the current management's unaltered or continued involvement, a co-owner's objection triggers an option for a buy out of the objecting co-owner's TIC interest (without a corresponding option to buy out his non-objecting co-owners' interests if they do not purchase his interest). The option price to be paid for the objecting co-owner's TIC interest is his fractional portion of the property's fair market value (set by an appraiser chosen by a majority vote of TIC co-owners). The buy out provision places a co-owner at risk of a loss on his investment if he should object to the renewal in a down market.

Normally, a co-owner objecting to management has a reasonable basis for doing so, namely that management procedures and policies are deteriorating the future worth of the property, requiring new management to take corrective action to preserve and build up equity in the property.

Hence, the property's present fair market value at the time of a co-owner's objection, especially in syndicated property which attracted §1031 monies, is an amount less than the price paid by the group to acquire the property (usually from the syndicator or a related entity) since poor management has deteriorated its worth.

Accordingly, if the non-objecting TIC co-owners exercise their option to purchase the objecting TIC co-owner's co-ownership interest, they will most likely be able to pay an amount less than the price paid by the objecting co-owner when he initially acquired his fractional interest in the property.

Resale by an individual TIC as §1031 property

Consider a syndicator who seeks to bring together several property owners and cash investors to form a group to co-own an income-producing property located by the syndicator. They will take title as **TICs**, each for their fractional share of undivided ownership, based on the pro rata value of their contribution to the purchase price.

The entire property is or will be leased to a single tenant. The tenant will be either a single user of the property or a master tenant with the right to sublet portions of the premises. Either way, the lease is a triple-net lease which imposes no responsibility on the co-owners for maintenance of the property or the supplying of any tenant services.

The co-ownership agreement places no restrictions on each co-owner's ability to sell or encumber their individual TIC interest. Also, **no voting** is established to sell, release or encumber the whole of the property. Thus, any *alienation* of the entire ownership of the real estate requires **unanimous approval** of all the co-owners — the essence of the conduct required for a TIC ownership to avoid the status of a tax partnership.

Based on these co-ownership arrangements, the syndicator requests of the IRS an **advance ruling** stating the arrangements for the TIC investment do not establish the investors as tax partners or members in an entity. On receipt of the IRC ruling, the fractional interest of a co-owner vested as a TIC can be acquired or sold as like-kind property.

Thus, an investor's acquisition of a fractional interest in a TIC investment group (with §1031 monies), which is the subject of an IRS advance ruling that the group is not a tax partnership, allows the profits an investor realizes on the sale of his property to qualify for the §1031 profit tax exemption by buying replacement property. [Rev. Proc. 2002-22]

The advance ruling for audits

To receive an **advance ruling**, the syndicator of a TIC co-ownership arrangement must, as a minimum, present extensive documentation to the IRS. In particular, the syndicator must demonstrate the following conditions exist:

1. Title will be vested in the name of all co-owners as TICs to their fractional or percentage ownership based on their proportionate contribution to the purchase of the property.

2. The co-owners will share in the income, profit and losses based on their percentage ownership.

3. No more than 35 participants will be co-owners, with husband and wife considered one participant.

4. The co-owners will not file a joint partnership return, will not operate the property under a common business name and the co-ownership agreement will not classify the co-owners as shareholders, members or partners.

5. The co-ownership agreement may provide for a right of first refusal to anyone (co-owner, manager, syndicator or lessee) to acquire a co-owner's fractional interest should the co-owner decide to sue for a partition and sale of the property. The fractional interest will be sold at a price set as the fair market value of the property at the time the right to purchase is exercised.

6. Any sale, encumbrance, lease, management or release agreement may only be entered into by unanimous approval of all co-owners (and no one related to the investment may hold a co-owner's power of attorney to act on his behalf).

7. Each co-owner may sell, encumber or lease his fractional ownership interest in the real estate without any prior restraints or approvals needed to permit the transfer. Should a transfer occur, a right of first refusal may exist in favor of any co-owner, the syndicator or the tenant to purchase the fractional interest transferred (based on the current market value of the entire property).

8. Any advances made by any other co-owner, the syndicator or manager to cover a co-owner's failure to meet a call for additional funds must be recourse and due within 31 days.

9. A co-owner may grant an option to purchase his interest to anyone. The price to be paid is the co-owner's fractional share of the whole property's fair market value on the date the option is exercised, however, no guaranteed buy out (put option) can be held by a co-owner to sell to anyone involved in the investment or the property.

10. A property manager may be hired for a period of no more than one year, with the contract renewable by unanimous agreement of the co-owners. He may be anyone except a lessee of the property, may collect rents, pay expenses incurred for the services to be provided to tenants as part of the rent, make distributions to co-owners from one bank account, prepare annual profit and loss statements for each co-owner's proportionate share of income, expenses, interest and depreciation, place insurance, negotiate leases to be executed only by unanimous approval of the co-owners and receive a fee in an amount comparable to fees received by competitive brokers. This fee cannot be based on a percentage of distribution to co-owners.

11. No lender providing funds for the investment program may be a related person to the co-owners, the syndicator, manager or lessee.

12. The syndicator may not sell any co-owner an interest in the property for less than the fractional interest's proportionate share of the whole property's fair market value (and services rendered by the syndicator to form the group), and no promotional fee or contribution by a co-owner may be contingent on the financial success of the investment program. [Rev. Proc. 2002-22]

However, in spite of all these threshold arrangements to obtain a ruling, the IRS provides **no rules or guidelines** for the syndicator's actual formation of a group of co-owners outside the confines of a ruling. Further, the IRS provides **no guidance** for their audit on a co-owner's sale or exchange of a fractional co-ownership interest which is not the result of an advance ruling. The IRS only provides a procedure for requesting an advance ruling by a syndicator based on a very limited set of facts.

As a legal complication, an investment program designed to qualify for an advance ruling from the IRS and sold to investors in California most likely creates a risk of loss for the co-owners which is controlled by *California's securities law* and the *Subdivided Lands Act (SLA)*. Ironically, both laws require more protection for investors than is required by the IRS for the TIC to qualify for an advance ruling regarding the non-partner status of a fractional co-ownership interest sold or acquired in a §1031 reinvestment plan.

The dilemma of an entity

An LLC or LP entity is typically used in **real estate syndications** to structure the co-ownership by investors of real estate. The use of an entity is both a more practical and prudent title holding arrangement than a TIC vesting.

For example, California's property tax laws cause a **reassessment** of the property vested in an LLC or LP only when more than 50% of the ownership of the LLC or LP is assigned to others by the original members of the LLC or LP.

Conversely, when title for the same co-owners is vested as TICs, each co-owner who conveys his TIC interests to others (including other co-owners), triggers reassessment of the fractional portion he conveyed. Thus, property taxes rise on each conveyance of a fractional interest, not just the 100% reassessment when a change of more than 50% of the original ownership in an LLC or LP eventually occurs.

Also, a **voluntary conveyance** or encumbrance by a co-owner of his interest in the property (as required to be allowed without restraint to receive federal non-partner status) may not concern other co-owners. However, a judgment lien imposed by a creditor on a vested co-owner's interest in title and a foreclosure by way of a judicial sale of the interest becomes an **involuntary conveyance** of the co-owner's interest to another person.

The creditor foreclosing or another party will acquire the debtor's co-ownership interest in the property. On acquisition as the highest bidder, they will in all likelihood file for the partition and eventual sale of the entire property, i.e., a forced sale by a creditor which an LLC or LP vesting avoids.

Another issue for vested co-owners is the release of their names to tenants as required on acquisition or change of management unless they appoint an agent for service of process. An LLC or LP vesting avoids the **public release** of their names since the co-owners are secreted behind a title holding entity they have formed — the LLC or LP vesting — to either own or simply hold title in trust for the co-owners.

Most important of all, the co-owner is *shielded from liability* by the use of an entity for any uninsured obligation he may incur as an owner of the property.

Thus, LLC or LP vestings are preferable for those co-owners not concerned about managing their profit tax avoidance when they invest or withdraw their investment from the group.

Acquiring a fractional interest

Consider an investor who sells his ownership interest in §1031 real estate. The investor is either the sole owner of the property or the owner of a fractional interest in property co-owned by a group. The investor has located a replacement property with an equity far greater than the net proceeds from his sale.

The seller of the replacement property is unwilling to sell on terms consisting of a purchase-money note carried back for the balance due the seller after a down payment. Further, the investor is unwilling (or unable) to commit additional cash funds himself.

However, the investor has solicited another investor who will join with him as a co-owner and contribute the additional funds needed to cash out the seller's equity and purchase the property.

A purchase agreement is entered into to acquire the property. On closing, the two investors take title to the property as TICs, each to an undivided fraction of the title in proportion to their contribution of cash toward the purchase.

They enter into a co-ownership agreement to spell out the arrangements they have agreed to between themselves regarding:

- the **management and operation** of the ongoing rental of the property; and

- the management of their **ownership interest** in the property to sell, encumber or lease (long-term) their interests or the entire property.

The co-ownership agreement addresses their **arrangements for management** of the entire property, as well as each individual's management of their fractional ownership interest, as follows:

1. Title will be vested as a tenancy in common.

2. The property will be managed by one of the investors (or a broker) as the property manager for a one-year period with authority to locate tenants, enter into and enforce short-term leases and rental agreements in his own name, provide normal and customary tenant services, repair and maintenance of the property and maintain a bank account in the manager's name for deposits or receipts from the tenants and disbursements for expenses, mortgage payments and distributions to the co-owners.

3. The co-owners will share income, profits and losses in proportion to their fractional ownership share in the property.

4. Each co-owner will maintain separate tax reporting for his share of operating data and cost basis in his ownership interest and depreciation deductions. Each will report their income and losses on his Schedule E with no partnership return to be filed.

5. Any sale, encumbrance, long-term lease or property management contract for the property will be unanimously approved by the co-owners.

6. The right of each co-owner to sell, encumber or partition their fractional ownership interest in the property will be unrestrained by any approval or consent by the other co-owner.

An **option to purchase** either another co-owner's fractional interest or the whole property may be granted to a co-owner or the syndicator who packaged the investment program.

Also, a **right of first refusal** may be granted to co-owners (or the syndicator) to be exercised on another co-owner's decision to sell, encumber or partition his fractional interest in the property.

The price paid on the exercise of the purchase rights is a pro rata amount of the fair market value of the entire property based on the co-owner's fractional ownership interest in the property.

Does the co-ownership agreement establish a *tax partnership* which would disqualify the sale of a co-owner's TIC interest from use of the §1031 profit tax exemption?

No! Neither co-owner is entering into a business relationship with any tenant by providing services unrelated to the rent paid for the property, nor are they sharing income received by a third party who is operating a business providing tenants with services unrelated to operating the rental, such as laundry, food, maid service or towels and linens.

Further, as TIC co-owners, they **unanimously approve** the hiring of a property manager who has authorization to carry out only those managerial steps necessary to operate the rental property, including customary landlord services and the repair and maintenance necessary to protect the property's improvements and conserve the property's value.

Thus, the co-owner has not relinquished his common law right of a TIC to act independently of the other co-owner to sell, encumber, enter into long-term leases and partition the property. No trade name, no joint operating (bank) account and no partnership agreement have been used or entered into to coordinate any sale, further encumbrance or long-term lease of the property.

The only "pooling" by the co-owners is the capital investment and its income, operating expenses and mortgage obligations of the ongoing ownership. Each co-owner has retained the ultimate property right to unilaterally withdraw from the investment by sale, encumbrance or partition without the consent of the other co-owner.

An alternative available for the vesting of a co-owner's interest is the use of a wholly owned, one-man LP or LLC for the **vesting** of his fractional interest. Title to his fractional ownership interest would be held in the name of his LP or LLC as a TIC with all other co-owners. Such a vesting for his undivided fractional interest would be considered by the IRS as title held by a *disregarded entity*. [26 Code of Federal Regulations §301.7701-3]

As a **disregarded entity**, an individual co-owner's use of his solely-owned LLC for the vesting of his fractional share of ownership would have absolutely no tax impact on the *non-partner status* of the co-owner's undivided interest.

If title to the entire property is vested in an entity such as an LP or LLC, the co-owners' arrangements must be limited so the entity is merely **holding title** for each individual co-owner, as TICs. Further, the entity and the co-owners will not file a partnership return (as ten or less are already excused from doing so). The operating agreement for the LP or LLC needs to establish the entity holding title has no ownership interest in the property, and is acting solely as a trustee holding title for the co-owners. [Rev. Rul. 79-77]

A vesting change to benefit a partner

A multiple-unit, income-producing real estate project is owned and operated by an investment group as an unincorporated association structured as an LP or LLC.

A broker operates the property as the property manager, locating tenants, entering into leases, contracting for routine repairs and maintenance, depositing all rents into his trust account, disbursing funds for payment of operating expenses and mortgage payments and distributing spendable income to the co-owners.

The investment group (ten or less) does not file an IRS 1065 return and a K-1 information statement on annual operating income, expenses, interest, and depreciation is not handed to the co-owners, since these filings are not required. [Rev. Proc. 84-35]

Each co-owner separately reports his fractional share of each year's rental operations on Schedule E of his return based on information provided him by the property manager.

One of the co-owners is now selling his fractional interest to another co-owner or an outside party.

The price or value the co-owner receives for his fractional interest exceeds his adjusted cost basis remaining in this investment. Thus, the co-owner will take a profit on the sale or exchange, which for tax purposes must be reported, unless *exempt* or *excluded*. [IRC §1001]

While the co-owner desires to get out of the investment, he does not want to report the profit and pay taxes. He needs all the net proceeds from the sale, undiminished by taxes, to invest in his personal trade or business.

The co-owner locates other property which he will acquire for his own account and use as the premises which houses his business.

The property the co-owner wants to buy will be used in the co-owner's *trade or business* (or rented to his corporate business). Thus, the property he will acquire qualifies as §1031 property since it will be *held for productive use* in his trade or business. [IRC §1231]

Editor's note — If the property acquired is rented to the co-owner's corporate business, it will then be a rental classified as §1031 investment property, not §1031 business property. [IRC §1221]

To structure the sale of his fractional co-ownership interest in the investment group as the first leg of a §1031 reinvestment plan, the LLC or LP will convey to the co-owner by grant deed an undivided interest in the real estate equal to the co-owner's percentage share in the partnership.

Thus, a **liquidation** of the co-owner's interest in the partnership occurs as a *distribution in kind* of the partnership asset — conveyance of his pro rata share in title, a non-taxable event. As a result of the conveyance, the partnership becomes a TIC with the prior partner who now holds title to a fractional interest in the real estate as a TIC. As a TIC, the co-owner by the TIC agreement is given all the rights to alienate his TIC interest, unrestrained, while agreeing to the centralized management of the property's maintenance and customary tenant-related services for a short period of time (not more than one year).

Now, as owner of a TIC interest in real estate and no longer a partner in the partnership, the co-owner immediately sells (or exchanges) and conveys by grant deed his newly acquired TIC interest to a third party. The cash receipts of the sale are used to acquire the real estate he has located as the replacement property to complete his §1031 reinvestment plan.

Has the co-owner held ownership to the TIC interest for a sufficient length of time and for the right reasons to qualify the TIC ownership for the §1031 profit tax exemption?

Yes! The co-owner acquired ownership of the TIC interest with **no intention of liquidating** his investment in real estate by "cashing out." Thus, the co-owner held the TIC interest, unrestrained by the need for prior consent from the co-owners on his sale of his interest. The co-owner's only intent is to make money by remaining **continuously invested** in real estate.

The duration of his ownership in any one particular property, such as his ownership of the TIC interest, is not of concern. It is that the ownership must be held either for productive use in a trade or business or for investment. Since it was so held, the continuation of his investment after a sale by acquiring an ownership interest in replacement property (no matter it be for a long or short period of time) demonstrated the intent required to **remain unliquidated** in real estate investments. [**Bolker** v. **Commissioner** (9th Cir. 1985) 760 F2d 1039]

Editor's note — For property used in a trade or business to qualify as §1031 property, ownership must be retained for a period of one year. [IRC §1231]

The §1031 by a twist of Schedule E

A lack of understanding seems to exist among taxpayers, CPAs and drafters of IRS forms regarding the consequences of IRC partnership classification for fractional ownership interests, 1065/K-1 co-ownership reporting forms, the exemption from filing by partnerships comprising ten or less members and Schedule E filing by co-owners.

Thus, an **unintended application** of the §1031 exemption from profit tax reporting permits the profit taken on the sale of a fractional interest in a group investment which would otherwise be classified as a *tax partnership* to go unreported.

For example, when co-owners in an investment group file their individual returns, they report the operating data for rental properties on Schedule E, attached to their annual 1040 return. The partnership does not file a return nor provide K-1 reports.

Schedule E lists the co-owners' proportionate share of income, expenses, interest and depreciation separately. No reference is made (unless volunteered) to the aggregate data generated by the combined ownership of the real estate described in Schedule E.

The property data itemized by the individual co-owner on his Schedule E are but an **undisclosed fraction** of the income, expenses and deductions of the property identified on the co-owner's Schedule E. So far, so good during the ownership of the property.

But on the sale of the ownership interest in real estate listed in Schedule E, the IRS does not know (without an audit or a gratuitous disclosure) whether the interest sold is:

- an ownership **interest in a tax partnership** and thus excluded from tax-free treatment [IRC §1031(a)(2)(D)]; or
- a TIC ownership **interest in the asset** itself which, if unrestrained in its alienation rights, qualifies as §1031 property.

Thus, Schedule E fails to request information from the taxpayer on whether:

- the property ownership is connected by arrangement to additional tenant services paid for separate from rent; or
- the interest listed is a fractional interest.

Likewise, the IRS §1031 disclosure form does not inquire into whether the interest sold or exchanged:

- is a fractional interest in property;
- a fractional ownership interest in a partnership which owns the property; or
- a sole ownership interest in the property. [See IRS Form 8824]

Thus, a co-owner's annual reporting of his fractional interest on Schedule E (or F or C), and the sale and replacement of the interest on a §1031 disclosure form, does not trigger automatic audit or disallowance by the IRS. As a result, the exemption from profit taxes declared by the taxpayer is cleared, without a question about the possible tax partner status of the owner whose fractional interest is sold or acquired.

Editor's note — A school of thought holds the view that these deficiencies in the IRS forms produce the result intended by a more friendly and lenient IRS. However, this might not be the case. [Rev. Proc. 2002-22]

Chapter 14 Securities aspects of syndication

This chapter discusses the securities risks that exist in real estate development, lending and business operations co-owned as group investments.

Economic risks of real estate excluded

When a group of investors are brought together by syndication, whether structured to own real estate as a limited liability company (LLC) or other form of co-ownership — tenancies-in-common (TICs), corporations, limited partnerships (LPs), etc. — the syndicator must have an understanding of the social purpose underlying state and federal securities laws if he is to avoid **promotional activities** controlled by securities law.

The classic federal definition of a *security* relationship is:

- an **investment** of money;
- a **common enterprise** based on the mutual success or failure of the group in its investment goals; and
- an **expectation of profits** produced by the **efforts of others**, not just by the property. [**Securities and Exchange Commission** v. **W. J. Howey Co.** (1946) 328 US 293]

In application, the purchase and ownership of real estate by any group of investors involves both the elements of an **investment** and a **common enterprise**. Thus, the syndicator's formation of a group for an investment in real estate has the potential for creating a *securities risk*.

However, to create a security, the investment program must contain the third element — profit that is produced by others through an activity that *creates value* in the property. A **securities risk** arises when the investor releases control of his cash contribution, and it remains under the syndicator's or someone else's control until the promised value-creating activity is completed.

The risk created by a person's promise to perform an activity that **creates value** in a property is distinguished from a group investment that does not present a securities risk and remains outside the securities law.

To be a security, the investment program sold to the group of investors must provide for a **return of the original investment** based on a promise, by the syndicator or someone else, of future physical development or other change of use for the real estate acquired, that must be completed before the investment goal can be attained.

However, the mere formation of a group of investors by a syndicator to purchase and operate an existing income-producing real estate project for income (or to hold land for profit on resale), does not involve a securities risk. Here, the expectation of a return is based on the performance of the property in the marketplace, subject to economic conditions that affect all properties. The investors are not counting on the efforts of the syndicator or any other person to produce improvements or to develop a use for the property after the invested money has been released from the investor's further control.

Also, LLC ownership is merely a **business structure** used as a form of group ownership of the asset acquired in a real estate investment program. Thus, soliciting and offering cash investors fractional membership interests in an LLC (or as tenants in common) formed to fund the acquisition of an existing income-producing property is not, without analyzing other activities in the investment program, the offering of a security.

Conversely, an investment group formed to develop real estate or undertake an ongoing resale marketing program, farming operation or business opportunity, regardless of the entity or form of vesting chosen for the group, contains securities risks. To create a corporate securities risk the investors' capital must be placed at a **risk of loss** through the need to complete significant value-adding activities after the acquisition of the property. Also, the syndicator's selection of a property for acquisition after the investor relinquishes control of his cash, called a *blind pool*, is an activity controlled by the securities law.

A group investment program containing an activity that constitutes a securities risk imposes a duty on the syndicator soliciting investors' capital to comply with the securities law. Exemptions exist that remove some investment programs containing securities risks from control under the securities law.

Unless exempt, the syndicator first reports to the appropriate government agency:

- the California Department of Corporations (DOC) to comply with state securities rules and to qualify for a permit; or
- a registration with the Securities Exchange Commission (SEC) to comply with federal law.

Failure to qualify or register the sale of non-exempt corporate securities exposes the syndicator who creates the securities risk to civil and criminal liability.

A prudently selected property in a structured investment program avoids ownership activities that place the investors' capital at a risk of loss, such as after-closing development, blind pool asset selection or collective post-acquisition coordination with others (rental pooling). These ownership activities create a relationship between the investors and the syndicator, or others, that is classified as a *corporate security*.

Existing asset vs. securities risks

A group of investors purchases a newly constructed, but unoccupied apartment building. The syndicator who solicited the investors to become co-owners serves as manager for the group and the property. The investors have the right to cancel the property management agreement with the syndicator by removing him as the manager on 30 days' notice.

The investment program eventually fails to be a financial success. The local economy and its exploitation by the syndicator does not produce enough tenants to occupy the property. Thus, the amount of rental income received is insufficient to pay operating expenses and installments on the purchase-assist loan. The investment fails and is liquidated by foreclosure or other sale.

The co-owners make a demand on the syndicator for a return of their investment funds, plus the legal rate of interest (10%). They claim the purchase of the complex, when coupled with the property management agreement, creates a corporate security that was neither exempt from the securities law nor qualified by the DOC. The co-owners claim they relied on the syndicator's **management expertise** to rent out units in the newly constructed building and create a *return on the capital* they invested in the LLC.

Does the syndicator who merely manages property in competition with other like-type properties impose a liability on himself for the return of the co-owner's capital?

No! A corporate security is not created by the existence of property management activity or the promise or expectation of an annual return on their investment. Members of an LLC or TIC **retain control** over the management of the property. They have the right to terminate any property management agreement and the manager by a vote of the co-owners. Further, they can replace management with other management, as it is a service readily available in the local brokerage community.

Here, the investors did not place their capital at risk in reliance on the skill and effort of another to **create value** in the property. Instead, they acquired a fully-improved, existing asset in exchange for the funds invested, on the chance the rental market place will allow their investment to prosper.

Also, they retained ultimate control over management since they could change management at any time. The investors bought the property as the investment, not the syndicate manager or his management expertise (which was, instead, the subject of the property management agreement). [**Fargo Partners** v. **Dain Corp.** (8th Cir. 1976) 540 F2d 912]

Now consider a syndicator who sells small parcels of agricultural land planted with citrus trees to individual investors. Under a **service agreement** attached to each purchase agreement, the syndicator is to care for the trees and harvest and market the fruit produced by all the properties under his management. The term of the service agreement is 10 years.

The syndicator manages the groves on all the separate parcels by coordinating the ownership and operations of all the parcels as a single, large-scale farming operation. The syndicator has the knowledge and equipment required to conduct a successful farming operation and **produce and sell** the crop. Each investor is to receive a share of the net operating income from the syndicator's crop production based on their pro rata ownership of all parcels farmed under the service agreement, called a *pooling arrangement* or *horizontal commonality* investment.

In contrast to an apartment building co-owned by several investors with the syndicate manager locating tenants and renting existing units, an investment in a parcel of agricultural land operated as a farming business, coordinated and managed by the syndicator or others, contains a corporate securities risk. The investors rely solely on the expertise of the syndicator to **create a return** of their invested funds (capital) by **producing a crop**, then harvesting and selling it. As a further securities risk, he agreed to do so in cooperation with owners of other properties in a **pooling arrangement**.

Here, an investor who cancels the service agreement with the syndicator will not be able to independently operate his parcel of land and its grove with any economy to be successful. Operating separately from the owners of other parcels he will not be able to readily hire another operator to coordinate farming operations with the owners of other parcels as a *collective* to produce and market crops. The **financial success** of the operation requires all the parcels in an economy of scale to be operated as one, using special equipment and skills possessed by the syndicator.

Thus, even though the transaction was structured as a sale of a parcel of real estate to an individual purchaser combined with a service agreement, the series of related transactions display the critical elements of a corporate security — a group investment with an expectation of profits and success inextricably interwoven with the efforts of others to **produce a crop** and market it to generate an income and, ultimately, a return of the investment. [W. J. Howey Co., *supra*]

Protecting the investor

The state and federal corporate securities laws exist to protect investors who risk their capital in **asset-creating investment schemes** offered by others. The social purpose is to give investors a reasonable opportunity to realize profits on their investment.

A securities risk is created under California securities law whenever:

- an investor places his funds at risk of loss; and
- assumes a passive role, giving control of essential asset selection, development, pooling or resale decisions exclusively to the syndicator or others.

A security is created when the syndicator or others promise to perform an activity that **creates value** after the close of the purchase. Unless the creative activity is completed successfully, value will not be added to the property and the expected return of capital will not occur.

In essence, the investor did not invest in an existing asset, but in the skill of someone else to create that valuable asset in the future. The expenditure of invested funds is no longer controlled by the investor, but by the syndicator or others. Activities that occur after closing and create a **securities risk** include:

- locating and selecting a property for acquisition, called a **blind pool**;
- obtaining government approval or permits for zoning or a higher and better use of the property;
- making further improvements or significant alterations to the property; or
- operating a business or farming operation that requires expenditures for inventory, production or sales.

Thus, for a security to exist, the syndicator must undertake an ongoing investment activity that continuously places the investor's capital at risk of loss until the promised value-adding activity is completed. The securities risk is contained in the management of money, whether obtained from the investors or borrowed funds, to improve the property, create the crop or obtain agency approvals for a new use to fulfill the purpose of the group investment.

Examples of activities that include a securities risk for investors in syndicated real estate transactions include:

- subdividing, improving or reselling the real estate (dealer activities);
- operating a business on the premises acquired rather than merely managing the rental of the real estate or the ownership of vacant land; and
- investing in trust deed notes.

The California securities law is designed to give investors a fair chance of realizing investment objectives promised to be performed and completed by others. The syndicator is responsible for returning the investor's capital if promises of development are not fulfilled by completing after-closing activities that create the significant value necessary to provide for a return of the investors' contributions. [**Silver Hills Country Club** v. **Sobieski** (1961) 55 C2d 811]

Controlled investments

The securities issue for the syndicate manager is to determine which investment activities include risk situations that trigger the application of the securities law.

The existence of a security is a matter of the *substance* of the transaction, not the *form* it has been given. The economic function of the transaction, rather than the title the transaction bears or the type of business form used, determines whether a securities risk exists.

Editor's note — An exception to the substance-over-form rule is the issuance of ***stock****. Any transaction that involves the issuance or transfer of investment certificates, which are formally called stock, is a controlled security, regardless of the economic substance of the investment in the stock. [****Landreth Timber Company*** *v.* ***Landreth*** *(1985) 471 US 681]*

For example, the citrus grove investment program reviewed above was structured as a sale of a parcel of improved agricultural property. Each investor became the sole owner of an individual parcel of land — a real estate sales situation that, without further development after the acquisition, does not contain a securities risk.

However, each owner has no reasonable ability to **independently control** or operate the property and produce and market a crop in the farming business they bought into. Success was entirely in the hands of the syndicator to create value for a return of their invested funds through the husbandry, production, marketing and sale of the crop, and the coordination by *pooling* with other owners.

Next, consider an investor who purchases a condominium unit through a real estate broker. Normally, the purchase of a residential unit does not constitute a corporate security (other than as controlled by the subdivision law.) However, the broker also arranges for the buyer to enter into a *rental pooling agreement* (RPA) with a vacation rental management company for the ongoing operation of the property. The broker has no connection to the management company employed in the RPA and receives no kickback or fee for the referral.

Under the RPA, the management company oversees a rental operation within the entire project in which the investor's unit is located. The property manager distributes spendable rental income to the investors of individual units based on their pro rata share of ownership participation in the RPA, not based on the actual performance of their separate units, an activity called *rental pooling*.

The RPA is a major inducement for the investor to purchase the condominium unit. The pooling arrangement enables him to locate tenants, rent the unit and collect rental income without being personally responsible for the day-to-day management of his unit. Critical to the investment is the sharing of these investment risks; he will share the income and expenses with everyone else within the "pool." More strategically, the investor plans to cover his monthly mortgage payments and assessments on the condominium out of the rental income.

Ultimately, due to market forces, not management, the unit fails to produce the level of rental income the investor expected. The investor seeks to recover his investment from the broker, claiming the purchase of the condominium coupled with the RPA was a *corporate security*, since the investor relied on the management efforts of others in the **joint operation** of several individually owned units to produce a return of his investment.

The broker claims he did not create a corporate security since the investor was not required to enter into the RPA as part of the agreement to purchase the condominium. Further, the broker was not in control of the management of the property.

Did the broker create a corporate security by arranging an RPA for the investor?

Yes! The purchase of the condominium unit coupled with the RPA was presented to the investor as two separately controlled components of a single investment scheme. The investor was induced by the broker to invest his funds in the common enterprise based on an **expectation of profits** produced by the efforts of others in a *pool and split* program — even though the broker himself was not the person responsible for coordinating the rental pooling effort.

Since the broker arranged for the investor to place his funds at risk on the close of escrow in anticipation of a future return generated by the efforts of others — the pooling and management of several separately owned properties under the RPA — a **securities risk** was created. [**Hocking** v. **Dubois** (9th Cir. 1989) 885 F2d 1449]

Subdivided parcels sold to groups

Now consider a developer who acquires numerous acres of real estate for the development of a planned community. The developer sells parcels within the planned development to groups formed as LLCs (or TICs). The parcels are advertised as being suitable for development as part of the planned community.

The developer does not promise to develop the parcels sold to the LLCs or to produce profits for the LLCs based on the development of the entire project, adjacent parcels, off-site infrastructure or any profit pooling arrangement.

One group of investors who acquired a parcel makes a demand on the developer and his broker for a return of their investment, claiming a security was created since they relied on the developer to complete the development of the planned community, which did not occur.

However, the group of investors had complete control over the parcel it acquired from the developer — nothing remained to be done after acquisition, except for the investors to wait for the market to deliver a profit or loss. Thus, no securities risk was created, only an economic risk. The transaction was merely a sale of real estate to the LLC, to hold for a profit on resale or later development as the group saw fit. [**De Luz Ranchos Investment, Ltd.** v. **Coldwell Banker & Company** (9th Cir. 1979) 608 F2d 1297]

Risk capital tests

State and federal courts apply slightly different tests to determine whether a securities risk exists in an investment program. In California, courts apply what is called the *risk capital test* to determine whether the investors in a syndicated real estate transaction benefit from securities law protection.

The California risk capital test requires the investors' capital to simply be placed at risk in a value-adding activity, **whether or not a profit** is expected or intended. Compared to federal securities law, the California securities law is further-reaching and covers more investment conduct.

The federal risk capital test, on the other hand, revolves around the element of the expectation of a profit on the investment in a value-adding activity. For a security to exist under the federal **risk capital test**, the investors must be induced to join the program by, among other activities, a promise that they will profit from their capital investment.

Personal use coupled with development

Under the California risk capital rule, a syndicator's mere promise of future profits does not create a securities risk unless it is accompanied by the promise to perform an activity that creates value, such as development.

For example, a developer sells memberships in a yet-to-be-built country club to investors. Later, when the developer fails to complete construction of the country club, the investors make a demand on the developer for their investment to be returned. They claim the developer violated California securities law since the club memberships sold were unqualified and non-exempt securities in a construction project.

The developer claims the country club memberships are not controlled by California securities laws since the memberships merely provide for personal recreation and involve no expectation of a profit.

However, unlike federal securities law with its profit-driven test, an expectation of profit is not of concern to the California securities law. Here, the sale of memberships was coupled with a securities risk. The investors risked their capital on a "yet- to-be-built" project, relying on the developer to **complete the construction** of the country club after the members released their investment funds to acquire membership in the group's ownership of the property. [Silver Hills Country Club, *supra*]

Promised returns without development

To avoid creating a security under California's risk capital test, the selection of a specifically **identified parcel** of real estate for acquisition must exist before the release of invested funds. Even then, the only business that may be conducted after acquiring the property is either the location of tenants and rental of the property or the ultimate resale of the unaltered property at a profit.

If, on closing a purchase escrow, the investor receives **full value** for his investment in the form of a fixed asset, such as a share ownership in an existing parcel of real estate and a guarantee of a minimum profit, no security is created. The investor's capital is no more at risk than if he had purchased the asset outright, with or without a promise of profits. [**Hamilton Jewelers** v. **Department of Corporations** (1974) 37 CA3d 330]

In another example, a syndicator completes his due diligence investigation on a property he located and decides it is suitable for syndication. A detailed **investment circular** is prepared. The circular states the real estate will not be further developed or improved, but simply owned and operated for what it is — a rental income property.

The investors solicited by the syndicator know they will receive an existing fixed asset for their money. The property will not be altered, further improved or converted to another use after acquisition. Thus, their capital is not subjected to a securities risk — only the **economic risks** of locating tenants and incurring expenses in the rental marketplace, activities experienced by all property owners.

All money invested in real estate is, to some extent, at risk of loss due to fluctuating property values brought about by economic conditions, natural hazards, etc., called *marketplace risks*. However, marketplace risks merely affect the level of income, profit or loss. Income and profits (or losses) from ongoing rental operations in the local economy are not the concern of securities laws.

Exemptions when securities risks exist

A large number of investments that contain a securities risk are *exempt* by statute from control under the securities laws.

Investment programs offered by banks and savings and loans (S & Ls) are exempt from securities law, as are *nonpublic offerings* by individuals.

The **nonpublic offering exemption** is the most useful exemption available to syndicators who put together an investment program which includes an activity containing a securities risk. The nonpublic offering exemption, called the *35-or-less interrelationship rule*, applies if:

- the investors do not number more than 35 (husband and wife counting as one);
- all investors have a meaningful, pre-existing business or personal relationship with the syndicator;
- the investors will not resell or distribute the interests they acquire; and
- the solicitation of investors does not involve public advertising. [Calif. Corporations Code §25102(f)]

Thus, when an investment program does contain securities risks, such as exist in a construction or development project, the syndicator does not need to be further concerned with the securities law if his program meets the requirements of the **35-or-less interrelationship rule** for the nonpublic offering of a security.

If a securities risk does not exist in the investment program, the **solicitation of investors** by public advertising is not an activity which places the investors' funds at risk.

Consider an LLC that seeking investors for a California property yet to be developed. The LLC files paperwork with the SEC granting it the ability to sell an unlimited amount of memberships in the LLC, which are to be structured as limited private placement offerings. Under a federal securities law exemption, these type of offerings can only be made to *accredited investors*. [17 Code of Federal Regulations §230.501]

The LLC solicits a small business owner with whom it has no prior relationship to invest in the LLC, without qualifying the business owner under the restrictions for a limited private placement offering.

The California DOC issues the LLC a desist and refrain order, claiming the LLC violated state securities law by publicly offering a membership with the LLC in a value-adding venture without the LLC being qualified or registered with the DOC.

The LLC sought to dismiss the desist and refrain order, claiming the DOC's authority was preempted by the LLC's filing with the SEC as a non-securities offering.

Is the LLC exempt from the DOC's desist and refrain order due to its filing with the SEC as a non-securities offering?

No! Here, the state securities law controls since the LLC did not adhere to the federal exemption requiring it to contact only **accredited investors**. Thus, it fell outside the scope of the SEC limited private placement filing and was subject to state securities law. [**Consolidated Management Group, LLC** v. **Department of Corporations** (2008) 162 CA4th 598]

Disclosure of securities and limitations on recovery

Consider a syndicator whose investment program contains a securities risk activity such as conversion or development. To solicit investors, he posts his offering in the recreational rooms of condominium projects and *mobilehome* parks he has an interest in. He does not obtain a permit nor does he register the sale of the investment program with the DOC or SEC.

Here, the syndicator publicly offered his investment opportunity containing a securities risk to anyone visiting the recreational rooms. Thus, his investment program was a **non-exempt offering** of a security. As a result, any investor in the program can recover the full amount of his investment from the syndicator, plus 10% interest from the date of investment, less any distributions the investor has received. [Corp C §25503]

However, the investor's recovery of his investment under California securities laws is subject to a time constraint, called a *statute of limitations*. The limitation places a time deadline beyond which an investor is barred from filing a claim for the recovery of money. An action to recover the investor's funds must be filed within the earlier of:

- two years after the date the investor funds the investment; or
- one year after the investor discovers the securities law violation. [Corp C §25507]

If the syndicator, as part of his investment memorandum, discloses securities permits have not been obtained, the investor will be aware of the potential violation from the beginning. Thus, the investor's recovery under the California securities law will be subject to the one-year statute of limitations for filing his complaint.

Until the one-year limitations period expires, the investor in an investment program that contains a securities risk and does not qualify for an exemption or was not qualified for investors by the DOC, may unilaterally withdraw his investment funds at any time (plus interest and less any distribution of earnings). However, when the one-year period has expired following disclosure and the close of escrow, the syndicator is no longer liable for any claims to money for securities violations.

Realistically, if an investor is willing to contribute his funds to a real estate syndication in the first place, he is unlikely to withdraw and file an action within one year. Real estate investments are unlikely to be observed as having gone sour within one year.

Thus, even if the syndicator is certain his investment program contains no activities that are securities risks that place the investors' funds at risk of loss after acquisition of the property, a disclosure that no permit exists limits the syndicator's exposure to civil monetary liability by commencing the one year statute of limitations. [See **first tuesday** Form 372 §1.7]

Chapter 15 — Trust deed investment for groups

This chapter discusses the documentation necessary for a syndicator to publicly solicit multiple investors to make or purchase a trust deed loan.

Fractionalizing a trust deed

A borrower retains a loan broker to solicit and arrange a large loan to be secured by real estate. The borrower and the broker enter into a loan agreement contingent on the broker locating trust deed investors with sufficient cash reserves to fund the loan.

To locate trust deed investors, the broker runs newspaper advertisements soliciting private investors with modest amounts of funds to form a trust deed investment group consisting of **ten or less investors**. The loan is too large for any one of the investors to handle alone or prudently carry the entire risk of loss.

As investors respond to the advertisements and subscribe, their funds are placed in a loan escrow trust account set up specifically for this loan, until sufficient funds accumulate to fund the loan. When fully funded, the borrower signs and delivers his note and trust deed to the loan escrow. Both documents reflect the fractional ownership of the note and trust deed by the numerous contributing investors named as beneficiaries, based on their proportional investments.

The broker concurrently enters into a **collection and servicing agreement,** signed by each of the investors, to service the note and trust deed as their collection agent. The broker is authorized by the agreement to:

- advance payments to the investors from his own funds to cover any delinquent installments; and
- bid in the property for his own account in the event of a foreclosure under the investors' trust deed.

Has the broker created an investment risk that is regulated by California corporate securities law?

Yes! The broker's *singular activity* of fractionalizing the investment in a note and trust deed among multiple private investors creates a corporate security. [**People** v. **Schock** (1984) 152 CA3d 379]

A loan broker syndicating trust deeds creates a *corporate security* if:

- he accepts money from an investor or executes promissory notes **before locating** the trust deed investment, called a *blind pool investment* [See Chapter 14]; or
- the trust deed is **fractionalized** among multiple investors rather than acquired by one trust deed investor for his own account.

However, a broker can package *multiple-lender* trust deed investments and avoid securities violations, provided his conduct falls within one of two readily available exemptions from the securities law.

Securities exemptions

When fractionalizing a trust deed investment and thus creating a securities risk, a syndicator has two options for complying with the securities law.

The first is the **nonpublic offering exemption**, called the *35-or-less interrelationship rule*. To use this exemption, the syndicator must have a meaningful, pre-existing business or personal relationship with investors he privately solicits for the trust deed investment. [See Chapter 14]

However, trust deed investment groups need not be limited to persons with a pre-existing relationship with the loan broker. A loan broker may publicly solicit trust deed investors by filing a *notice permit* with the Department of Real Estate (DRE) under the second claim of exemption option, called the *ten-or-less trust deed investment plan*.

The ten-or-less rules and reporting

The ten-or-less trust deed investment scheme allows a loan broker to publicly solicit investors to acquire a fractional interest in a trust deed note. To qualify for this ten-or-less exemption, the loan broker must comply with the following rules and guidelines:

1. A **multi-lender transaction notice** form, also called a *notice permit* or *claim of exemption,* is prepared and filed with the DRE within 30 days after:

    1.1 the loan broker **originates or sells** the first trust deed note made or acquired by ten-or-less investors he solicited from the public [See Form 545 accompanying this chapter];

    1.2 any change to the information in the original notice filed with the DRE, called an amendment [Calif. Business & Professions Code §10238(a)]; or

2. **Advertising** for trust deed investors must:

    2.1 include the name of the broker and his license identification;

    2.2 comply with sections 260.302 and 2848 of California Regulations, Title 10, regarding advertising criteria, wording and disclosures; and

    2.3 include no reference to compliance with the DRE notice permit procedure since it infers merit or approval by the DRE. [Bus & P C §10238(c)]

3. The **trust deed** securing the note includes:

    3.1 California real estate in which the broker, directly or indirectly, has no ownership interest or right to acquire an ownership interest [See §5 below];

    3.2 no agreement for the future subordination of the trust deed; and

    3.3 priority as a first trust deed if it is security for a **construction loan**, with funds disbursed as construction progresses; including ten percent retention until expiration of the mechanic's lien period, and covered by title insurance providing priority against mechanic's liens. [Bus & P C §10238(d)]

4. The note must not be a *promotional note* secured by a junior trust deed, or a trust deed subject to a future subordination agreement, executed on:

    4.1 lots in a subdivision;

    4.2 unimproved property; or

    4.3 newly constructed, unsold property. [Bus & P C §10238(d)]

5. The fractional interests may be sold by a real estate broker, acting as either a **principal** or an **agent,** to finance:

    5.1 his acquisition of real estate at a foreclosure sale under a trust deed he is servicing or one that he originally sold to investors; or

    5.2 the broker's resale of real estate he acquired at a foreclosure sale under a trust deed he was servicing or originally sold to investors. [Bus & P C §10238(e)]

6. The fractional interests are **sold to ten or less investors**. [Bus & P C §10238(f)]

    6.1 An unlimited number of persons may be publicly solicited to purchase an interest. [Bus & P C §10238(f)(2)]

    6.2 A husband and wife, or any retirement funds or entity wholly owned by an individual and/or their spouse, that acquire a fractional interest are treated as one investor. [Bus & P C §10238(f)(3), §10238(f)(4)]

    6.3 Any organization, such as a partnership, limited liability company (LLC) or corporation that was not specifically formed for the purpose of investing in the fractional interest is treated as one investor. [Bus & P C §10238(f)(5), §10238(f)(6)]

    6.4 Each investor must sign a statement indicating he meets minimum income or net worth standards. [See **first tuesday** Form 373]

    In it he must state his total investment in the trust deed note from all sources (directly or through his spouse, retirement fund or controlled entity) represents:

    a. ten percent or less of his net worth (excluding cars, home and furnishings); or

    b. ten percent or less of his current or prior year's adjusted gross income (AGI) for his Internal Revenue Service (IRS) 1040 tax return. [Bus & P C §10238(f)(1)]

MULTI-LENDER TRANSACTION NOTICE

(RE 860)

GENERAL INFORMATION

- This notice is filed pursuant to Section 10238 of the Business and Professions Code.
- AN AMENDED NOTICE MUST BE FILED BY THE BROKER WITHIN 30 DAYS OF ANY MATERIAL CHANGE IN THE INFORMATION REQUIRED TO BE SET FORTH HEREIN.
- Mail completed notice to:
  Mortgage Loan Section
  2201 Broadway
  P.O. Box 187000
  Sacramento, CA 95818-7000

MULTI-LENDER TRANSACTION NOTICE

CHECK ONE

☐ ORIGINAL NOTICE ☐ AMENDED NOTICE

1. NAME OF BROKER CONDUCTING TRANSACTION UNDER SECTION 10237

2. BROKER LICENSE ID#	3. MONTH FISCAL YEAR ENDS	4. BROKER'S TELEPHONE NUMBER

5. FIRM NAME (IF DIFFERENT FROM 1)

6. STREET ADDRESS (MAIN LOCATION)

CITY	STATE	ZIP CODE

7. MAILING ADDRESS (IF DIFFERENT FROM 6)

CITY	STATE	ZIP CODE

8. SERVICING AGENT — IDENTIFY BY NAME, ADDRESS, AND TELEPHONE NUMBER THE PERSON OR ENTITY WHO WILL ACT AS THE SERVICING AGENT IN TRANSACTIONS PURSUANT TO SECTION 10229 (INCLUDING THE UNDERSIGNED BROKER IF THAT IS THE CASE)

9. TOTAL NUMBER OF MULTI-LENDER NOTES ARRANGED	10. TOTAL NO. OF INTERESTS SOLD TO INVESTORS ON THE MULTILENDER'S NOTES

11. INSPECTION OF TRUST ACCOUNT — BEFORE ANSWERING THIS QUESTION, REVIEW THE PROVISIONS OF PARAGRAPH (3) OF SUBDIVISION (K) OF SECTION 10238. ***(See reverse.)***

CHECK ONLY ONE OF THE FOLLOWING:

☐ The undersigned broker is (or expects to be) required to file reports of inspection of its trust account(s) with the Real Estate Commissioner pursuant to paragraph (3) of subdivision (k) of Section 10238.
- Amount of multilender payments collected last fiscal quarter:
- Total number of investors due payments last fiscal quarter:

☐ The undersigned broker is NOT (or does NOT expect to be) required to file reports of inspection of its trust account(s) with the Real Estate Commissioner pursuant to paragraph (3) of subdivision (k) of Section 10238.

Certification *The contents of this notice are true and correct.*	SIGNATURE »	DATE
	TYPED NAME OF BROKER	
	SIGNATURE OF BROKER OR DESIGNATED OFFICER OF CORPORATE BROKER »	
	TYPED NAME OF PERSONS SIGNING THIS NOTICE	

PAGE ONE OF TWO — FORM 545 (RE 860)

Section 10238(k) of the Business and Professions Code

(k) The notes or interests shall be sold subject to a written agreement that obligates a licensed real estate broker, or a person exempted from the licensing requirement for real estate brokers under this chapter, to act as agent for the purchasers or lenders to service the note or notes and deed of trust, including the receipt and transmission of payments and the institution of foreclosure proceedings in the event of a default. A copy of this servicing agreement shall be delivered to each purchaser. The broker shall offer to the lenders or purchasers the services of the broker or one or more affiliates of the broker, or both, as servicing agent for each transaction conducted pursuant to this article. The agreement shall require all of the following:

(1) (A) That payments received on the note or notes be deposited immediately to a trust account maintained in accordance with this section and with the provisions for trust accounts of licensed real estate brokers contained in Section 10145 and Article 15 (commencing with Section 2830.1) of Chapter 6 of Title 10 of the California Code of Regulations.

(B) That payments deposited pursuant to subparagraph (A) shall not be commingled with the assets of the servicing agent or used for any transaction other than the transaction for which the funds are received.

(2) That payments received on the note or notes shall be transmitted to the purchasers or lenders pro rata according to their respective interests within 25 days after receipt thereof by the agent. If the source for the payment is not the maker of the note, the agent shall inform the purchasers or lenders of the source for payment. A broker or servicing agent who transmits to the purchaser or lenders the broker's or servicing agent's own funds to cover payments due from the borrower but unpaid as a result of a dishonored check may recover the amount of the advances from the trust fund when the past due payment is received. However, this article does not authorize the broker, servicing agent, or any other person to issue, or to engage in any practice constituting, any guarantee or to engage in the practice of advancing payments on behalf of the borrower.

(3) If the broker or person who is or becomes the servicing agent for notes or interests sold pursuant to this article upon which the payments due during any period of three consecutive months in the aggregate exceed one hundred twenty-five thousand dollars ($125,000) or the number of persons entitled to the payments exceeds 120, the trust account or accounts of that broker or affiliate shall be inspected by an independent certified public accountant at no less than three-month intervals during the time the volume is maintained. Within 30 days after the close of the period for which the review is made, the report of the accountant shall be forwarded as provided in paragraph (6) of subdivision (j). If the broker is required to file an annual report pursuant to subdivision (o) or pursuant to Section 10232.2, the quarterly report pursuant to this subdivision need not be filed for the last quarter of the year for which the annual report is made. For the purposes of this subdivision, an affiliate of a broker is any person controlled by, controlling, or under common control with the broker.

(4) Unless the servicing agent will receive notice pursuant to Section 2924b of the Civil Code, the servicing agent shall file a request for notice of default upon any prior encumbrances and promptly notify the purchasers or lenders of any default on the prior encumbrances or on the note or notes subject to the servicing agreement.

(5) The servicing agent shall promptly forward copies of the following to each purchaser or lender:

(A) Any notice of trustee sale filed on behalf of the purchasers or lenders.

(B) Any request for reconveyance of the deed of trust received on behalf of the purchasers or lenders.

7. Each investor is given all the **rights of a lender** and each interest sold to investors is on the same terms.

   7.1 The investor's interest in the trust deed as a named beneficiary will be recorded before a release of the funds from escrow. [Bus & P C §10238(g)]

8. Based on the combined principal amounts of the fractionalized note and any prior encumbrances (bonds and trust deeds), as well as the current market value of the real estate as stated in a written **opinion of value** by an appraiser or the broker, the loan-to-value (LTV) ratio must not exceed the greater of:

   8.1 80% for owner-occupied, single family residences;

   8.2 75% for non-owner-occupied, single family residences;

   8.3 65% for commercial and income-producing property;

   8.4 65% for single-family, residential-zoned lots or parcels;

   8.5 50% for undeveloped property zoned for commercial or residential use;

   8.6 35% for other real estate; or

   8.7 the percent of value set by any private mortgage insurance (PMI) coverage issued for the fractionalized note. [Bus & P C §10238(h)(1); see **first tuesday** Form 234]

Editor's note — If unique circumstances exist, the broker may exceed the statutory LTV ratios if he can justify in writing his reasons for exceeding the limits. However, the LTV ratio must never exceed 80% of improved real property or 50% of unimproved property, except for single family, residentially zoned lots or parcels, for which the LTV ratio cannot exceed 65%.

The broker must keep the statement containing the justification for exceeding the LTV limits in his files. Also, he must provide the investors with a copy of the LTV statement with the lender disclosure statement. [Bus & P C §10238(h)(2); see Form 235-1 accompanying this chapter]

9. The beneficiaries' operating agreement provides:

   9.1 a default on the note or trust deed is a default on all the investors' interests in the note; and

   9.2 a vote of investors holding more than 50% of the ownership interests in the note controls the action taken on a default in the trust deed and the selection of the broker, servicing agent or other persons who will act on behalf of the investors. [Bus & P C §10238(i)]

10. The broker must disclose to the investors the **identity** of the specific trust deed note he is under contract to arrange or buy, thus eliminating the formation of **blind pool trust deed investments** under the ten-or-less notice of exemption. [Bus & P C §10238(j)]

    10.1 On the sale of fractional interests, the investors' funds must be deposited in a neutral escrow and disbursed on the recording of the investors' individual interests as named beneficiaries in the trust deed and note. [Bus & P C §10145(b)]

    10.2 The broker must maintain records of the loan transaction, clearly identifying the manner of the receipt and disbursement of the investors' funds. [Bus & P C §10238(j)(3)]

11. A **servicing agreement** for managing the trust deed investment is entered into by the investors, in which the broker (or other licensed person) agrees to receive payments on the note, disburse the payments received to the investors and begin foreclosure proceedings on a default in the trust deed. [See **first tuesday** Form 237]

    The trust deed loan collection agreement contains provisions for:

    11.1 the deposit of payments into the broker's trust account on their receipt;

    11.2 notice that payments deposited will not be commingled with any other funds, and will not be used for any purpose other than the servicing of the trust deed;

    11.3 the disbursement to the investors of their pro rata share of the payments within 25 days of receipt;

    11.4 notice to the investors if the source of payments is other than the borrower;

    11.5 no guarantee or advance of funds for payments by the broker, unless the advance is due to the borrower's check being dishonored;

    11.6 filing a request for notice of default (NOD) on prior encumbrances; and

    11.7 sending investors a copy of any notice of trustee's sale (NOTS), filed on their behalf, or a request for reconveyance. [Bus & P C §10238(k); see **first tuesday** Form 237]

12. **Material facts** will be disclosed to the investors on a DRE designed form.

    12.1 The terms of the sale of undivided interests in the trust deed note include:

      a. if it is an **origination** of a trust deed loan, the name and address of the escrow holder, date for closing and an itemized list of the costs incurred by the borrower and the investors on the origination [Bus & P C §10238(l)(1)(B); see Form 235-1];

      b. if it is the acquisition of **an existing note**, its sale price, any premium or discount on the principal balance and unpaid interest, the effective rate of return, name and address of the escrow holder and the itemized costs incurred by the seller and the investors on the sale [Bus & P C §10238(l)(1)(A); see **first tuesday** Form 235-2]; or

      c. if the note is secured by a **blanket trust deed** as a lien on more than one parcel of real estate, additional disclosures of the identification and value of each parcel, the dollar amount of equity in each property after an apportionment of the amount of the trust deed note to each parcel and the resulting LTV ratio for each parcel. [Bus & P C §10238(l)(1)(C); see **first tuesday** Form 235-4]

    12.2 All other relevant material facts affecting the sale of the trust deed note.

13. On request from an investor, the broker must notify the investor of the names and addresses of all other investors in the note. [Bus & P C §10238(m)]

14. The broker is prohibited from acquiring, directly or indirectly, an **option to buy** the interests of the investors in the note or to acquire the real estate as part of the initial transaction to acquire, originate

LENDER/PURCHASER DISCLOSURE STATEMENT

(Loan Origination) (RE851A)

DISCLOSURE STATEMENT SUMMARY

Note: If this is a multi-lender transaction and more than one property secures the loan, you should also refer to the attached Lender/Purchaser Disclosure Statement Multi-Property (Cross Collateralization) Addendum (RE 851D).

AMOUNT OF THIS LOAN *(SEE PART 3)*	MARKET VALUE OF PROPERTY (SEE PART 8)	TOTAL AMOUNT OF ENCUMBRANCES SENIOR TO THIS LOAN *(SEE PART 9)*
$ 0.00	$ 0.00	$ 0.00
TOTAL AMOUNT OF ENCUMBRANCES ANTICIPATED OR EXPECTED TO BE JUNIOR TO THIS LOAN *(SEE PART 9)*	PROTECTIVE EQUITY (MARKET VALUE MINUS THIS LOAN AND TOTAL SENIOR ENCUMBRANCES)	TOTAL LOAN TO VALUE (SEE PART 10G)
$ 0.00	$ 0.00	0.00 %

PART 1 BROKER INFORMATION

NAME OF BROKER	REAL ESTATE LICENSE ID#
BUSINESS ADDRESS	TELEPHONE NUMBER
NAME OF BROKERS REPRESENTATIVE	

PART 2 BROKER CAPACITY IN TRANSACTION

THE BROKER IDENTIFIED IN PART 1 OF THIS STATEMENT IS ACTING IN THE FOLLOWING CAPACITY IN THIS TRANSACTION: (CHECK AS APPLIES)

☐ A. Agent in arranging a loan on behalf of another

☐ B. Principal as a borrower of funds from which broker will directly or indirectly benefit other than through the receipt of commissions, fees and costs and expenses as provided by law for services as an agent.

☐ C. Funding a portion of this loan. *(Multi-lender transactions are subject to Business and Professions Code Section 10238.)*

IF MORE THAN ONE CAPACITY HAS BEEN CHECKED, PROVIDE EXPLANATION HERE.

IF ‹BŽHAS BEEN CHECKED, THE BROKER INTENDS TO USE FUNDS FROM THE LENDER/PURCHASER IN THIS TRANSACTION FOR:

PART 3 TRANSACTION INFORMATION

(CHECK IF APPLICABLE)

☐ THERE IS MORE THAN ONE PROPERTY SECURING THE LOAN. IF MULTI-LENDER LOAN, YOU SHOULD ALSO REFER TO ATTACHED RE 851D.

TERM OF LOAN	PRIORITY OF THIS LOAN (1ST, 2ND, ETC.)	PRINCIPAL AMOUNT	YOUR SHARE IF MULTI-LENDER TRANS.
		$	$
INTEREST RATE % ☐ VARIABLE ☐ FIXED	(CHECK ONE) ☐ AMORTIZED ☐ PARTIALLY AMORTIZED	☐ INTEREST ONLY	***THE TRUST DEED WILL BE RECORDED.***
PAYMENT FREQUENCY ☐ MONTHLY ☐ WEEKLY	APPROXIMATE PAYMENT DUE DATE	AMOUNT OF PAYMENT $	YOUR SHARE IF MULTI-LENDER TRANS. $
BALLOON PAYMENT ☐ YES ☐ NO	APPROX. BALLOON PAYMENT DUE DATE	AMOUNT OF BALLOON PAYMENT $	YOUR SHARE IF MULTI-LENDER TRANS. $

Balloon Payment„ A balloon payment is any installment payment (usually the payment due at maturity) which is greater than twice the amount of the smallest installment payment under the terms of the promissory note or sales contract.

The borrower/vendee may have to obtain a new loan or sell the property to make the balloon payment. If the effort is not successful it may be necessary for the holder of the note/contract to foreclose on the property as a means of collecting the amount owed.

There are subordination provisions. .... ☐ Yes ☐ No

If YES, explain here or on an attachment.

PAGE ONE OF SIX — FORM 235-1 (RE 851A)

PART 4 MULTI-LENDER TRANSACTIONS

NAME OF ESCROW HOLDER	ANTICIPATED CLOSING DATE
ADDRESS OF ESCROW HOLDER	
ESTIMATED LENDER COSTS $ ____ $ ____ $ ____ TOTAL $ 0.00	ESTIMATED BORROWER COSTS *Broker will provide you a copy of the "mortgage loan disclosure statement" given to the borrower or a separate itemization of borrower's costs.* TOTAL $ ____

Servicing

You will be a joint beneficiary with others on this note and you should request a list of names and addresses of the beneficiaries as of the close of escrow from the broker or servicing agent. The beneficiary(ies) holding more than 50% interest in the note may govern the actions to be taken on behalf of all holders in the event of default or other matters. See Civil Code Section 2941.9.

Loan To Value

GENERALLY the aggregate principal amount of the notes or interests sold, together with the unpaid principal amount of any encumbrances upon the real property senior thereto, shall not exceed the following percentages of the current market value of the real property as determined in writing by the broker or qualified appraiser.

Single-family residence, owner-occupied 80%

Single-family residence, not owner-occupied 75%

Commercial and income-producing properties 65%

Single-family residentially zoned lot or parcel which has installed off-site improvements including drainage, curbs, gutters, sidewalks, paved roads, and utilities as mandated by the political subdivision having jurisdiction over the lot or parcel 65%

Land which has been zoned for (and if required, approved for subdivision as) commercial or Residential development 50%

Other real property 35%

The percentage amounts specified above may be exceeded when and to the extent that the broker determines that the encumbrance of the property in excess of these percentages is reasonable and prudent considering all relevant factors pertaining to the real property. However, in no event shall the aggregate principal amount of the notes or interests sold, together with the unpaid principal amount of any encumbrances upon the property senior thereto, exceed 80 percent of the current fair market value of improved real property or 50 percent of the current fair market value of unimproved real property, except in the case of a single-family residentially zoned lot or parcel as defined above, which shall not exceed 65% of current fair market value of that lot or parcel. A written statement shall be prepared by the broker that sets forth the material considerations and facts that the broker relies upon for his or her determination which shall be disclosed to the lender or note purchaser(s) and retained as a part of the broker's record of the transaction.

NOTE: If more than one property secures this loan, you should also refer to attached RE 851D.

PART 5 SERVICING ARRANGEMENTS

If the loan is to be serviced by a real estate broker you must be notified within ten (10) days if the broker makes any advances on senior encumbrances to protect the security of your note. Depending on the terms and conditions of the servicing contract, you may be obligated to repay any such advances made by the broker. (Note: There must be a servicing agent on multi-lender transactions.) The broker may not guarantee or imply to guarantee, or advance any payments to you unless a securities permit is obtained from the Department of Corporations.

CHECK APPROPRIATE STATEMENTS

- ☐ THERE ARE NO SERVICING ARRANGEMENTS *(Does not apply to multi-lender transactions.)*
- ☐ BROKER IS THE SERVICING AGENT
- ☐ ANOTHER QUALIFIED PARTY WILL SERVICE THE LOAN
- ☐ COPY OF THE SERVICING CONTRACT IS ATTACHED

IF BROKER IS NOT SERVICING AGENT, WHAT IS THE RELATIONSHIP BETWEEN THE BROKER AND SERVICER?	COST TO LENDER FOR SERVICING ARRANGEMENTS *(EXPRESS AS DOLLAR AMOUNT OR PERCENTAGE)* *PER* ☐ MONTH ☐ YEAR ☐ *PAYABLE* ☐ MONTHLY ☐ ANNUALLY ☐

NAME OF AUTHORIZED SERVICER, IF ANY	
BUSINESS ADDRESS	TELEPHONE NUMBER

PART 6 BORROWER INFORMATION

SOURCE OF INFORMATION

☐ BORROWER ☐ BROKER INQUIRY ☐ CREDIT REPORT ☐ OTHER (DESCRIBE)

NAME		CO-BORROWER'S NAME	
RESIDENCE ADDRESS		CO-BORROWER'S RESIDENCE ADDRESS	
OCCUPATION OR PROFESSION		CO-BORROWER'S OCCUPATION OR PROFESSION	
CURRENT EMPLOYER		CO-BORROWER'S CURRENT EMPLOYER	
HOW LONG EMPLOYED?	AGE	HOW LONG EMPLOYED?	CO-BORROWER'S AGE

SOURCES OF GROSS INCOME *(LIST AND IDENTIFY EACH SOURCE SEPARATELY.)*	MONTHLY **AMOUNT**	CO-BORROWER SOURCES OF GROSS INCOME (LIST AND IDENTIFY EACH SOURCE SEPARATELY.)	MONTHLY AMOUNT
Gross Salary	$	Gross Salary	$
OTHER INCOME INCLUDING: Interest	$	*OTHER INCOME INCLUDING:* Interest	$
Dividends	$	Dividends	$
Gross Rental Income	$	Gross Rental Income	$
Miscellaneous Income	$	Miscellaneous Income	$

TOTAL EXPENSES OF ALL BORROWERS ***(DO NOT COMPLETE IF BORROWER IS A CORPORATION)***

Payment of Loan being obtained	$	Spousal/Child Support	$
Rent	$	Insurance	$
Charge Account/Credit Cards	$	Vehicle Loan(s)	$
Mortgage Payments *(include taxes and property insurance)*	$	Other *(federal & state income taxes, etc.)*	$

TOTAL GROSS MONTHLY INCOME OF BORROWER(S)	TOTAL MONTHLY EXPENSES OF BORROWER(S)
$ 0.00	$ 0.00

The borrower has filed for bankruptcy in the past 12 months. ☐ Yes ☐ No

If YES, the bankruptcy has been discharged or dismissed. ☐ Yes ☐ No

❖ ***THE FOLLOWING STATEMENTS ONLY APPLY IF THE BORROWER IS A CORPORATION, PARTNERSHIP OR SOME OTHER FORM OF OPERATING BUSINESS ENTITY.***

Copies of a balance sheet of the entity and income statement covering the indicated period have been supplied by the borrower/obligor and are attached. If no, explain on addendum. ☐ Yes ☐ No

If YES, Date of balance sheet ____________

Income statement period *(from-to)* ____________

Financial Statements have been audited by CPA or PA. ☐ Yes ☐ No

Additional information is included on an attached addendum ☐ Yes ☐ No

PART 7 PROPERTY INFORMATION

Identification of property which is security for note. *(If no street address, the assessor's parcel number or legal description and a means for locating the property is attached.)*

(CHECK IF APPLICABLE)

☐ THERE IS MORE THAN ONE PROPERTY SECURING THE LOAN. IF MULTI-LENDER LOAN, YOU SHOULD REFER TO ATTACHED RE 851D.

STREET ADDRESS		OWNER OCCUPIED ☐ NO ☐ YES
ANNUAL PROPERTY TAXES $ ☐ ACTUAL ☐ ESTIMATED	ARE TAXES DELINQUENT? ☐ NO ☐ YES	IF YES, AMT. REQUIRED TO BRING CURRENT $
SOURCE OF TAX INFORMATION		

PART 8 APPRAISAL INFORMATION

Estimate of fair market value is to be determined by an independent appraisal, copy of which must be provided to you prior to you obligating funds to make the loan. Note: You may waive the requirement of an independent appraisal, in writing, on a case by case basis, in which case the broker must provide a written estimate of fair market value. The broker must provide you, the investor, with the objective data upon which the broker's estimate is based. **In the case of a construction or rehabilitation loan, an appraisal must be completed by an independent, qualified appraiser in accordance with the Uniform Standards of Professional Appraisal Practice (USPAP).**

(CHECK IF APPLICABLE)

☐ THERE IS MORE THAN ONE PROPERTY SECURING THE LOAN. IF MULTI-LENDER LOAN REFER TO ATTACHED RE 851D.

FAIR MARKET VALUE (ACCORDING TO APPRAISER) *(Place this figure or brokers estimate of fair market value on line "F" of Part 10.)* $		DATE OF APPRAISAL
NAME OF APPRAISER (IF KNOWN TO BROKER)		PAST AND/OR CURRENT RELATIONSHIP OF APPRAISER TO BROKER (EMPLOYEE, AGENT, INDEPENDENT CONTRACTOR, ETC.)
ADDRESS OF APPRAISER		
DESCRIPTION OF PROPERTY/IMPROVEMENT		IS THERE ADDITIONAL SECURING PROPERTY? ☐ YES IF YES, SEE ADDENDUM. ☐ NO
AGE	SQUARE FEET	TYPE OF CONSTRUCTION
IF THE PROPERTY IS CURRENTLY GENERATING INCOME FOR THE BORROWER/OBLIGOR: ESTIMATED GROSS ANNUAL INCOME $		ESTIMATED NET ANNUAL INCOME $

PART 9 ENCUMBRANCE INFORMATION

Information is being provided concerning senior encumbrances against the property, to the extent reasonably available from customary sources (excluding the note described on page 1 Part 3). **Note:** You have the option to purchase a policy of title insurance or an endorsement to an existing policy of title insurance to insure your interest. You are entitled to a copy of a written loan application and a credit report to obtain information concerning all encumbrances which constitute liens against the property. This information may help determine the financial standing and creditworthiness of the borrower.

(CHECK IF APPLICABLE)

☐ THERE IS MORE THAN ONE PROPERTY SECURING THE LOAN. IF MULTI-LENDER LOAN, YOU SHOULD REFER TO ATTACHED RE 851D.

SOURCE OF INFORMATION

☐ BROKER INQUIRY ☐ BORROWER ☐ OTHER *(EXPLAIN)*

Are there any encumbrances of record against the securing property at this time?.................. ☐ YES ☐ NO

A. Over the last 12 months were any payments more than 60 days late? .... ☐ YES ☐ NO

B. If YES, how many? .... ____________

C. Do any of these payments remain unpaid? .... ☐ YES ☐ NO

D. If YES, will the proceeds of subject loan be used to cure the delinquency? .... ☐ YES ☐ NO

E. If NO, source of funds to bring the loan current. .... ____________

Encumbrances remaining and/or expected or anticipated to be placed against the property by the borrower/obligor after the close of escrow (excluding the note described on page 1).

ENCUMBRANCE(S) REMAINING *(AS REPRESENTED BY THE BORROWER)*

PRIORITY (1ST, 2ND, ETC.)	INTEREST RATE %	PRIORITY (1ST, 2ND, ETC.)	INTEREST RATE %
BENEFICIARY		BENEFICIARY	
ORIGINAL AMOUNT $	APPROXIMATE PRINCIPAL BALANCE $	ORIGINAL AMOUNT $	APPROXIMATE PRINCIPAL BALANCE $
MONTHLY PAYMENT $	MATURITY DATE	MONTHLY PAYMENT $	MATURITY DATE
BALLOON PAYMENT ☐ YES ☐ NO ☐ UNKNOWN	IF YES, AMOUNT $	BALLOON PAYMENT ☐ YES ☐ NO ☐ UNKNOWN	IF YES, AMOUNT $

ENCUMBRANCES EXPECTED OR ANTICIPATED *(AS REPRESENTED BY THE BORROWER)*

PRIORITY (1ST, 2ND, ETC.)	INTEREST RATE %	PRIORITY (1ST, 2ND, ETC.)	INTEREST RATE %
BENEFICIARY		BENEFICIARY	
ORIGINAL AMOUNT $	MATURITY DATE	ORIGINAL AMOUNT $	MATURITY DATE
MONTHLY PAYMENT $		MONTHLY PAYMENT $	
BALLOON PAYMENT ☐ YES ☐ NO ☐ UNKNOWN	IF YES, AMOUNT $	BALLOON PAYMENT ☐ YES ☐ NO ☐ UNKNOWN	IF YES, AMOUNT $

Additional remaining, expected or anticipated encumbrances are set forth in an attachment to this statement. .... ☐ Yes ☐ No

PART 10 **LOAN TO VALUE RATIO**

(CHECK IF APPLICABLE)

☐ THERE IS MORE THAN ONE PROPERTY SECURING THE LOAN. IF MULTI-LENDER LOAN, YOU SHOULD REFER TO ATTACHED RE 851D.

A. Remaining encumbrances senior to this loan *(from part 8)* .... $ 0.00

B. Encumbrances expected or anticipated senior to this loan *(from part 9)* .... + $______

C. Total remaining and expected or anticipated encumbrances senior to this loan .... = $ 0.00

D. Principal amount of this loan from page 1 part 3 .... + $ 0.00

E. Total all senior encumbrances and this loan .... = $ 0.00

F. Fair market value from page 4 part 8 .... ÷ $ 0.00

G. Loan to value ratio .... = ______%

Note: See Part 4 if multi-lender transaction.

BROKER VERIFICATION

The information in this statement and in the attachments hereto is true and correct to the best of my knowledge and belief.

SIGNATURE OF BROKER OR DESIGNATED REPRESENTATIVE	BROKER/CORPORATION ID#	DATE
➢		

ACKNOWLEDGMENT OF RECEIPT

The prospective lender/purchaser acknowledges receipt of a copy of this statement signed by or on behalf of the broker.

SIGNATURE OF PROSPECTIVE LENDER/PURCHASER	DATE
➢	

For licensing information, please refer to the Department of Real Estate's Web site located at www.dre.ca.gov.

or

You may call the DRE licensing information telephone number at 877-373-4542.

or service a fractionalized note. However, the broker, after completing the syndication of the note or entering into a service agreement, may later enter into an agreement to purchase an interest in the note or the real estate if it is negotiated at the time of his purchase. [Bus & P C §10238(n)]

15. If the broker sells, originates or services fractionalized notes, and the amount of payments received from all sources in any **three-month period** exceeds $125,000, or the number of all investors participating during a three-month period exceeds 120, the broker must:

    15.1 have his **trust account** inspected by a certified public accountant (CPA) and forward the CPA's trust account inspection report to the DRE within 30 days after the period in review [Bus & P C §10238(k)(3); see **first tuesday** Form 546];

    15.2 file an **annual report** on the status of the **trust account** with the DRE [Bus & P C §10238(o); see **first tuesday** Form 548]; and

    15.3 file an **annual report** of his **trust deed sales, originations** and **servicing** with the DRE. [Bus & P C §10238(p); see **first tuesday** Form 547]

No blind pools with Notice Permit

A trust deed broker receives funds from investors that he will later place in trust deed notes he will originate or select. To evidence his receipt of the funds, the broker executes interest-bearing promissory notes in favor of the investors.

As agreed with the investors, the broker later uses the funds handed him by the investors to purchase trust deed notes he selects. The broker collaterally assigns the notes and trust deeds to the investors to secure the promissory notes he previously executed.

An investor who loses money on the scheme demands the return of his funds, plus 10% interest from the date he delivered the funds to the broker. The investor claims the broker's trust deed investment program violates the securities law since the individual promissory notes issued to evidence the receipt of funds were not registered or qualified as corporate securities.

The broker claims no corporate securities risk exists since the notes became fully secured by the collateral assignment of trust deeds.

Has the conduct of the broker created a **corporate securities risk** that placed the transactions under the control of the securities law, requiring the broker to obtain a permit or qualify for an exemption?

Yes! The broker placed the investor's capital at risk of loss by an activity controlled by the securities law. The funds were handed to the broker in reliance on the broker's skill in the **later selection** and delivery of trust deed notes. The success of the investment was inextricably bound to the broker's **managerial expertise** in selecting a suitable investment after the investor released his funds by handing them to the broker without treatment as trust funds. The investor had no choice in the selection of the trust deed note acquired before his funds were put at risk. [**Underhill** v. **Royal** (9th Cir. 1985) 769 F2d 1426]

The mere acquisition or origination of one trust deed note by one investor, arranged by a trust deed broker and fully identified to the investor before he releases his funds, is **not** conduct that creates a security under the California risk capital test. When the investor advances funds through an escrow to purchase or originate a specifically identified trust deed note, the investor receives the full value of his investment by an absolute assignment or execution of the note, secured by a trust deed on real estate of sufficient current value.

However, a trust deed investment program does contain a securities risk when:

- funds are handed to the broker for release without first identifying the specific trust deed note and security interest to be acquired in real estate; and
- the investor relies on the skill and judgment of the broker to later locate and deliver a suitable trust deed investment for the funds he previously placed with the broker.

In a **blind pool investment**, the investor puts up his money before a trust deed is located for purchase. In practice, the funds will then be readily available to the broker for funding the acquisition of a trust deed note when he later locates one he deems to be of suitable investment quality.

The investor does not initially invest his capital in a trust deed, but in the **broker's expertise** to conduct due diligence investigations and to analyze and select a future trust deed investment. The broker is given carte blanche to use the investor's funds as he sees fit.

The securities risk is not in a trust deed, but in the performance of the **broker's promise** to later select and deliver to the investor a suitable trust deed note. Thus, lacking specificity of the investment, a corporate securities risk is created in the investment program entered into by this investor.

Chapter 16 — An overview of the LLC

This chapter examines the formation and taxation of a limited liability company, and the conversion of an existing limited partnership to a limited liability company.

The LLC vs. a limited partnership

A limited liability company (LLC) is a hybrid business entity. It combines limited liability advantages of a corporation under state law with the federal income tax treatment of a partnership. [Calif. Corporations Code §§17000 et seq.; Calif. Revenue and Taxation Code §§17941 et seq.]

Like a limited partnership, the LLC itself does not pay federal income taxes. Instead, all reportable income, profits and losses of the LLC are **passed through** to the members for individual tax reporting. The members, as individuals, pay federal and state income tax on their share of any LLC income and profits. California imposes a $900 flat fee on gross income of $250,000 to $499,999 from rentals. [Rev & TC §17942]

The LLC is an entity comparable to a limited partnership, but without a general (liability) partner. Limited liability in an LLC extends to all members, including the manager. Conversely, the managing general partner in a limited partnership is personally liable for the partnership's debts.

The syndicator in a limited partnership sometimes seeks to limit his liability by forming a one-man corporation to act as general partner for the partnership, rather than naming himself as the general partner. A **sole, corporate general partner** in a limited partnership creates a liability limitation situation for the managing syndicator similar to the LLC, with its limited liability extended also to the manager.

Taxwise, however, a limited partnership with a sole, corporate general partner is a co-ownership structure that is more regulated than an LLC. For instance, all partnerships with the same corporation as the sole general partner are taxed as corporations unless the corporate general partner owns assets with a net worth of at least 15% of the partners' contributions to all the partnerships, limited to $250,000 for total investor contributions up to $2,500,000. When contributions exceed $2,500,000, the net worth of the corporate general partner must be at least 10% of total contributions by partners. [Revenue Procedure 72-13]

Also, a limited partnership structured with a corporate general partner is unable to take advantage of the exemption from tax reporting available to small partnerships. Partnerships with ten or less partners are exempt from filing the Internal Revenue Service (IRS) 1065 return, but only if all partners are individuals. [Internal Revenue Code §6231(a)(1)(B)]

Taxwise, the LLC also resembles an S corporation. An LLC is essentially a small corporation (because of its state law corporate liability structure) that is treated as a partnership for income tax purposes. However, an LLC has fewer operating restrictions imposed on the participants and their investments than in an S corporation.

For example, the shareholders in an S corporation must be individuals (or estates, organizations or trusts in limited circumstances), and an S corporation may have no more than 100 shareholders. [IRC §1361(b)]

The members of an LLC, on the other hand, may include any type of legal entity, such as corporations, partnerships and other LLCs, along with individuals. Also, no limit is imposed on the number of members. [Corp C §17001(ae)]

For real estate syndication purposes, the LLC also resembles a real estate investment trust (REIT). REITs are unincorporated organizations formed for the purpose of group investment primarily in real estate. REITs provide limited liability for investors and pass-through of income for state and federal tax reporting by the investor. [Corp C §23000; IRC §856]

However, the REIT is not an appropriate syndication vehicle for group investments in local real estate. The LLC offers far more management flexibility and the same tax results for the participants.

For example, to qualify for federal tax reporting as a real estate investment trust, the REIT must have at least 100 shareholders and 75% of the REIT's business activities must be restricted to investments in real estate, trust deed notes, cash or government securities. [IRC §856(c)(4)]

No such restrictions apply to the LLC.

Further, an REIT must always qualify its investment program with the California Department of Corporations (DOC). Conversely, an LLC only needs to qualify its investment program if a securities risk exists for its members and no exemption applies. [Corp C §23000(b)]

Formation by filing articles

To form an LLC, the syndicator signs and files *Articles of Organization* using an LLC-1 form issued by the Secretary of State, the equivalent of the LP-1 used for limited partnership filings. The filing fee is $70. [Calif. Government Code §12190(b); see LLC-1 accompanying this chapter]

The $70 LLC-1 fee is for documents filed by mail. The Secretary of State charges an additional $15 counter fee for any LLC documents delivered in person.

The person signing the LLC-1 does not need to be a shareholding member of the LLC. In a typical real estate investment program, the LLC-1 will be signed by the syndicator acting alone. The syndicator then typically designates himself or an entity he controls as the managing member.

The LLC-1, when filed with the Secretary of State along with the $70 fee, establishes the LLC as a **legal entity** in the state of California. The filing provides limited liability for its members and manager. No further recording with the county is necessary. However, a certified copy of an LLC-1 and any other addenda or documents is typically recorded with the county recorder in the county where the LLC will hold title to real estate. [Corp C §17052(f)]

When recorded in county records, those dealing with the LLC, such as title companies, lenders, sellers, buyers, escrows, brokers and others, do not need to look any further than the LLC-1 in the county records to determine who to deal with — the manager, a group of managers or a majority in interest of members.

The LLC-1 form can be obtained from the Secretary of State's Sacramento office, from the branch offices of the Secretary of State or downloaded from the Secretary of State's website at *sos.ca.gov/business/be/forms*.

LLC-1

File # ____________________

State of California
Secretary of State

LIMITED LIABILITY COMPANY ARTICLES OF ORGANIZATION

A $70.00 filing fee must accompany this form.

IMPORTANT – Read instructions before completing this form.

This Space For Filing Use Only

ENTITY NAME (End the name with the words "Limited Liability Company," or the abbreviations "LLC" or "L.L.C." The words "Limited" and "Company" may be abbreviated to "Ltd." and "Co.," respectively.)

1. NAME OF LIMITED LIABILITY COMPANY

PURPOSE (The following statement is required by statute and should not be altered.)

2. THE PURPOSE OF THE LIMITED LIABILITY COMPANY IS TO ENGAGE IN ANY LAWFUL ACT OR ACTIVITY FOR WHICH A LIMITED LIABILITY COMPANY MAY BE ORGANIZED UNDER THE BEVERLY-KILLEA LIMITED LIABILITY COMPANY ACT.

INITIAL AGENT FOR SERVICE OF PROCESS (If the agent is an individual, the agent must reside in California and both Items 3 and 4 must be completed. If the agent is a corporation, the agent must have on file with the California Secretary of State a certificate pursuant to Corporations Code section 1505 and Item 3 must be completed (leave Item 4 blank).

3. NAME OF INITIAL AGENT FOR SERVICE OF PROCESS

4. IF AN INDIVIDUAL, ADDRESS OF INITIAL AGENT FOR SERVICE OF PROCESS IN CALIFORNIA	CITY	STATE	ZIP CODE
		CA	

MANAGEMENT (Check only one)

5. THE LIMITED LIABILITY COMPANY WILL BE MANAGED BY:

- ☐ ONE MANAGER
- ☐ MORE THAN ONE MANAGER
- ☐ ALL LIMITED LIABILITY COMPANY MEMBER(S)

ADDITIONAL INFORMATION

6. ADDITIONAL INFORMATION SET FORTH ON THE ATTACHED PAGES, IF ANY, IS INCORPORATED HEREIN BY THIS REFERENCE AND MADE A PART OF THIS CERTIFICATE.

EXECUTION

7. I DECLARE I AM THE PERSON WHO EXECUTED THIS INSTRUMENT, WHICH EXECUTION IS MY ACT AND DEED.

____________________ DATE

____________________ SIGNATURE OF ORGANIZER

____________________ TYPE OR PRINT NAME OF ORGANIZER

LLC-1 (REV 04/2007) APPROVED BY SECRETARY OF STATE

Editor's note — Although LLC forms can be obtained from any branch office or downloaded from the Secretary of State's website, only the Document Filing Support Unit in the Secretary of State's Sacramento office will accept LLC forms for filing.

The LLC-1 is a very limited and fairly simple document, intended mainly to:

- register the LLC with the state;
- establish it as a legal entity in order to provide limited liability to all managers and members (and a minimum tax of $800 annually to the state); and
- notify the public of the individual with the authority to bind the LLC by entering into agreements on its behalf.

In an addendum to the LLC-1, the syndicator might include an **alienation-restriction provision.** Such a provision assures members that the real estate vested in the name of the LLC cannot be sold, encumbered or subjected to a long-term lease without the consent of a majority in interest of the members. The provision serves to limit the manager's activities to the designated purpose of the LLC — to **own and operate** the real estate for the benefit of the members.

An LLC is commonly thought of as having two or more members. However, a single person can form and operate an LLC by filing **Articles of Organization** with the California Secretary of State. [Corp C §17050]

A one-man limited liability company is disregarded for purposes of federal income tax reporting by the sole owner of the LLC. [26 Code of Federal Regulations §301.7701-3]

Limited liability

The liability limitation for members of an LLC is slightly less extensive in its protection from debts than it is for limited partners in a limited partnership. The limited liability protection for the members of an LLC is the same as for the shareholders in a corporation, not limited partners in a limited partnership. [Corp C §17101(b)]

For example, the liability of a partner in a limited partnership is absolutely limited to the amount of their capital contribution. However, corporate shareholders — as well as members in an LLC — can be held generally liable for the debts of the corporation or LLC if it can be proven that the corporation or LLC exists solely to shield the shareholders from liability for their debts or actions.

In a limited partnership, the limited partners escape liability beyond the amount of their contributions. However, the general partner of the limited partnership is then personally liable for all partnership debts.

In a corporation or LLC, no member, officer or shareholder is generally liable for any of the entity's debts. Without personal liability for debts incurred by the LLC, an individual can use a corporate or LLC business entity to shield themselves from liability in the conduct of the investment. Conversely, some individuals carry on their personal activities behind a corporation or LLC that is merely a facade, called an *alter ego*, causing the shareholder to lose his liability shield.

A corporation, and thus an LLC, is considered an **alter ego** of a controlling shareholder if:

- the corporation or LLC is entirely dominated by a single individual or by a small group of shareholders or members;
- the economic interests of the corporation or LLC are indistinguishable from the interests of the shareholders or members; and
- an injustice would result from treating the shareholders' or members' acts as the acts of the corporation or LLC and not as their own. [**Stark** v. **Coker** (1942) 20 C2d 839]

Also, a corporation or LLC that is **undercapitalized** to meet its reasonably anticipated demands for cash is often considered an alter ego of the shareholders. If a corporation or LLC is not funded with a sufficient amount of capital when created, it will not have sufficient assets to pay off the debts it incurs in the **ordinary course** of business.

Sufficient capitalization is rarely an issue in real estate transactions since all funds needed to own the property, in the form of cash and mortgage money, must be raised before the property can be acquired.

If undercapitalized, a corporation or LLC is regarded as existing in name only, created to shield the shareholders or members from liability for personal debts incurred in the entity's name. [**Automotriz del Golfo de California S. A. de C. V.** v. **Resnick** (1957) 47 C2d 792]

Taxation by the FTB

To maintain the limited liability of its members as permitted by state law, the LLC must report and pay annual taxes and fees to the state.

Every LLC must pay an annual $800 minimum franchise tax, a tax also imposed on corporations and limited partnerships (LPs). [Rev & T C §§17941, 23153(d)(1)]

In addition to the minimum franchise tax, an LLC with over $250,000 in annual gross income (rents) is assessed an additional annual fee by the Franchise Tax Board (FTB) based on its gross income for that year. The fees, in addition to the $800 entity tax, are:

- $900 for a total gross income of $250,000 to $499,999;
- $2,500 for gross income of $500,000 to $999,999;
- $6,000 for gross income of $1,000,000 to $4,999,999; and
- $11,790 for gross income of $5,000,000 or more. [Rev & T C §17942(a)]

If applicable, these additional taxes are to be paid on or before the 15th day of the sixth month of the taxable year. Underpayment of these additional taxes due will result in an extra fee equal to 10% of the underpaid amount. [Rev & T C §17942(d)(1-2)]

An LLC formed solely for real estate syndication purposes that acquires income-producing property with a scheduled gross income of less than $250,000 will not be concerned with the additional tax. Thus, ownership of income property valued at roughly $1,500,000 to $2,000,000 based on gross income (and cost of operations) would not be subject to the annual "rental tax."

The LLC name

A syndicator selects a name for an LLC, which must end with the words "Limited Liability Company," or the initials "LLC" or "L.L.C." The words "Limited" and "Company" may be abbreviated to "Ltd." and "Co." [Corp C §17052(a)]

As a practical matter, the name selected for the LLC should reference the property purchased and operated by the LLC, such as the property's name or street address. The name of the LLC should **not** include the name of the manager or any of the members, in order to avoid making their ownership interests in the LLC easily traceable.

Also, the name may not include the words "bank," "insurance company," "insurer," "trust," "trustee," "incorporated," "inc.," "corporation" or "corp." [Corp C §17052(d)]

For example, a typical LLC name, created from the property's address, might be "Main Street Properties, a California Limited Liability Company."

An LLC name may be reserved by applying to the Secretary of State with a Name Reservation Request Form. For a fee of $10, the name is **reserved** for 60 days. An additional $10 counter fee will be charged if the form is delivered in person to the Secretary of State's public counter. [Corp C §17053; Gov C §12190(a); see LLC Name Reservation Request Form]

Alternatively, a syndicator can use a private filing service to reserve the LLC name or file the LLC forms. These companies charge a fee for these services. One such company is:

Corporation Service Company, 2711 Centerville Road, Wilmington, DE 19808, (800) 927-9800, www.incspot.com.

Preparing the LLC-1 articles

The LLC-1 Articles of Organization includes a space for stating whether the LLC will be managed by all members or by one or more *appointed managers*. For real estate syndication purposes, the syndicator will, in most cases, check the box indicating the LLC has one manager — the syndicator himself. Thus, he alone will be able to bind the LLC to buy, sell, encumber or lease real estate.

Also, the LLC syndicator must designate an agent for the service of process on the LLC-1 with an address in California, as is required of any statutory entity. The agent may be an individual or an entity. [Corp C §17057(b)]

For real estate syndication, the agent for service of process is usually the syndicator or his attorney.

In addition to the appointed manager, the LLC's operating agreement may provide for the appointment of officers such as president, secretary, treasurer, chief executive officer (CEO), chief financial officer (CFO), chief operating officer (COO) and so on. [Corp C §17154]

The officers do not need to be members or managers of the LLC. For example, an accountant or bookkeeper who is not a member of the LLC can be hired as treasurer or the CFO.

The LLC must have an office in the state of California where it maintains its records. LLC records include the names and addresses of all members and managers, copies of the articles of organization (LLC-1) and the operating agreement, copies of state and federal tax returns, financial statements and the

books and records of the current and past four fiscal years. A true copy of business records relevant to the amount, cost and value of all property owned, claimed, possessed or controlled within the county must be made available upon the request of the county assessor. [Corp C §§17057, 17058]

The LLC-12 Statement of Information must first be filed **within 90 days** after filing the articles of organization for the LLC. It must state the name and address of the LLC, its manager, agent for service of process and the type of business it conducts. The statement is then filed every two years thereafter during the calendar month in which the articles of organization were first filed. A $20 filing fee is required each time the LLC-12 is filed. [Corp C §17060; Gov C §12190(k); see LLC-12 accompanying this chapter]

If the information required in the filing has not changed since the previous year, the LLC may simply file the form, stating no changes have been made. [Corp C §17060(b)]

LLCs are not permitted to be licensed as real estate brokers. The Limited Liability Company Act prohibits LLCs from offering professional services to others in the name of the LLC for a fee, which includes the services of accountants, attorneys, physicians and real estate brokers. Some professions may conduct business and provide services under a parallel entity called a limited liability partnership (LLP), but not real estate brokers.

However, an LLC manager who is licensed as a real estate broker may act as the real estate agent representing the LLC as its broker, and collect a brokerage fee on transactions handled on behalf of the LLC. Also, an LLC can act as a principal in any real estate related transaction, with the same powers as a corporation, partnership or individual, to conduct any business, buy, sell, finance and lease property, sue or be sued, enter into agreements, etc. [Corp C §17003]

FTB tax reporting

LLCs are considered partnerships for tax reporting purposes, except for the annual California franchise tax and tax on rental income. [Rev & T C §28.5]

An LLC is required, like a partnership, to submit a state information return annually to the FTB. The form for filing an LLC information return is FTB Form 568. [Rev & T C §18633.5]

An LLC reporting as a partnership for federal income tax purposes is required to file a 1065 return annually with the IRS, unless the LLC qualifies for the ten-or-less small partnership exemption.

Additionally, if an LLC has nonresident members, it must file an FTB Form 3832, the Limited Liability Company Nonresident Members' Consent form. All nonresidents (both domestic and foreign) must sign Form 3832 to show consent for having their share of the distributed income from the LLC taxed in California. Each nonresident member must then file a California income tax return. [Rev & T C §18633.5(e)(1)]

If an LLC fails to obtain a nonresident member's signature on Form 3832, the LLC will be responsible for paying California taxes for that nonresident member at the highest marginal tax rate. The LLC may recover any taxes paid on the nonresident member's behalf from that nonresident member. [Rev & T C §18633.5(e)(1)]

Form 3832 must be filed with the information return:

- the first taxable period during which the LLC had nonresident members; or

- any taxable period during which the LLC had non-signing nonresident member. [Rev & T C §18633.5(f)]

An LLC must withhold taxes from income distributions made to nonresident members. Nonresident withholdings must be reported quarterly, as well as annually. [Rev & T C §18633.5(e)(1); see FTB Forms 592, 592-A and 592-F]

Federal small partnership exemption

Although it does not pay income taxes, a partnership — including LLCs since they automatically qualify as partnerships — is required, unless exempt, to file an information return with the IRS, reporting the income and losses passed through to the partners. [IRC §6031]

In addition, if an LLC has foreign national members, it must withhold federal taxes for any income distributions made to foreign nonresident members and remit taxes due from foreign nationals to the IRS on a quarterly basis. [IRC §1446]

The tax form for filing the LLC information return is the IRS Form 1065. The IRS 1065 return informs the IRS of the LLC's income and losses and identifies each member along with his share of the income and losses.

An LLC automatically qualifies as a partnership for federal income tax purposes. Thus, an LLC can avoid filing an IRS 1065 return if it qualifies under the *small partnership exemption*. [IRC §7701, IRS Letter Ruling 9543017]

An LLC or partnership with ten or less participants, all of whom are natural persons or estates (husband and wife are treated as one), is not required to file an IRS 1065 Form. [IRC §6231(a)(1)(B)]

The IRS has imposed further restrictions beyond the number of participants for the exemption. Even if the LLC has ten or less members, the IRS has ruled an LLC is not exempt from filing a 1065 return if:

- it has significant holdings;
- it is a "tier" entity, in which a parent entity holds interests in one or more sub-entities;
- each member's interest in the capital and profits is not owned in the same proportion; or
- all items of income, deductions and credit are not allocated in proportion to the owner's percentage of membership. [Revenue Procedure 81-11]

Generally, most small investment groups do not have significant holdings and do report income and losses based on their percentage of ownership. Despite the additional restrictions imposed by the IRS, an LLC formed for real estate syndication with ten or less members can avoid filing the IRS 1065 return. Each member reports his share of income, expenses, interest and depreciation in a schedule attached to his 1040 return, such as a Schedule E for rental ownership reporting although he was a tenant-in-common co-owner.

Converting a LP to an LLC

Many general partners who manage existing LPs convert their LPs to LLCs. A syndicator, as manager of an LLC, has a limited liability that stands in dramatic contrast to his general liability for property operations and loans as the general partner in an LP.

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State of California
Secretary of State

STATEMENT OF INFORMATION
(Limited Liability Company)

Filing Fee $20.00. If amendment, see instructions.

IMPORTANT — READ INSTRUCTIONS BEFORE COMPLETING THIS FORM

1. **LIMITED LIABILITY COMPANY NAME** (Please do not alter if name is preprinted.)

This Space For Filing Use Only

DUE DATE: [For forms preprinted by the Secretary of State.]

FILE NUMBER AND STATE OR PLACE OF ORGANIZATION

2. SECRETARY OF STATE FILE NUMBER	3. STATE OR PLACE OF ORGANIZATION

COMPLETE ADDRESSES FOR THE FOLLOWING (Do not abbreviate the name of the city. Items 4 and 5 cannot be P.O. Boxes.)

4. STREET ADDRESS OF PRINCIPAL EXECUTIVE OFFICE	CITY AND STATE		ZIP CODE
5. CALIFORNIA OFFICE WHERE RECORDS ARE MAINTAINED **(DOMESTIC ONLY)**	CITY	STATE	ZIP CODE
		CA	

NAME AND COMPLETE ADDRESS OF THE CHIEF EXECUTIVE OFFICER, IF ANY

6. NAME	ADDRESS	CITY AND STATE	ZIP CODE

NAME AND COMPLETE ADDRESS OF ANY MANAGER OR MANAGERS, OR IF NONE HAVE BEEN APPOINTED OR ELECTED, PROVIDE THE NAME AND ADDRESS OF EACH MEMBER (Attach additional pages, if necessary.)

7. NAME	ADDRESS	CITY AND STATE	ZIP CODE
8. NAME	ADDRESS	CITY AND STATE	ZIP CODE
9. NAME	ADDRESS	CITY AND STATE	ZIP CODE

AGENT FOR SERVICE OF PROCESS (If the agent is an individual, the agent must reside in California and Item 11 must be completed with a California address. If the agent is a corporation, the agent must have on file with the California Secretary of State a certificate pursuant to Corporations Code section **1505** and Item 11 must be left blank.)

10. NAME OF AGENT FOR SERVICE OF PROCESS

11. ADDRESS OF AGENT FOR SERVICE OF PROCESS IN CALIFORNIA, **IF AN INDIVIDUAL**	CITY	STATE	ZIP CODE
		CA	

TYPE OF BUSINESS

12. DESCRIBE THE TYPE OF BUSINESS OF THE LIMITED LIABILITY COMPANY

13. THE INFORMATION CONTAINED HEREIN IS TRUE AND CORRECT.

TYPE OR PRINT NAME OF PERSON COMPLETING THE FORM	SIGNATURE	TITLE	DATE

LLC-12 (REV 03/2007) APPROVED BY SECRETARY OF STATE

To convert an LP to an LCC, the general partner and his partners must approve a plan of conversion which includes:

- the terms and conditions of the conversion, including any desired effective date of the conversion;
- the places of organization of both the LP and the LLC to which the LP will be converted;
- the name of the newly-created LLC after conversion;
- the manner of converting the LP's interests into the interests of the LLC. Each partner of the LP must receive a percentage interest in the profits and capital of the newly-created LLC in an amount equal to his percentage interest as a partner at the time of the conversion [Corp C §15911.02];
- the Articles of Organization and the operating agreement for the new LLC; and
- any other details requested by the LP partners or required by law. [Corp C §15911.03(a)]

Unless the partnership agreement provides for a greater or lesser percentage for approval, this plan of conversion must be approved by:

- all of the LP's general partners; and
- a majority of the LP's limited partners. [Corp C §15911.03(b)]

After the conversion plan has been approved by the partners, the LP must file with the California Secretary of State a statement of conversion on the LLC's Articles of Organization, which includes:

- the name and Secretary of State file number for the LP;
- a statement that the conversion plan was approved by the required percentage of general and limited partners, with a specification of each class required to vote and the percentage needed;
- the form of the converted entity (in our case, an LP); and
- the mailing addresses of the LP's:
    - agent for service of process; and
    - chief executive officer. [See LLC-1A]

This statement of conversion must be signed by all general partners. Additional signatures may be provided on a 8 ½ x 11 sheet of paper attached to the LLC-1. [See **first tuesday** Form 251]

The cost of filing the LLC-1A with the Secretary of State is $70. An additional $15 fee is charged for LLC-1A filings made in person at the Secretary of State's Sacramento office.

Once the LLC-1A is filed with the Secretary of State, the LP ceases to exist as a separate entity. The LLC succeeds to all the property, debts, and liabilities of the "disappearing" LP. No further act or documentation is required to transfer the partnership's real or personal property to the LLC. [Corp C §15911.06(c)]

LLC-4/8

State of California
Secretary of State

LIMITED LIABILITY COMPANY
SHORT FORM CERTIFICATE OF CANCELLATION

There is no fee for filing a Short Form Certificate of Cancellation.

IMPORTANT – Read instructions before completing this form.

This Space For Filing Use Only

FILE NUMBER	**ENTITY NAME** (Enter the exact name of the domestic limited liability company.)
1. Secretary of State File Number	2. Name of Limited Liability Company

REQUIRED STATEMENTS (The following statements should not be altered.)

3. a) This Short Form Certificate of Cancellation is being filed **within twelve (12) months** from the date the Articles of Organization were filed with the Secretary of State;
   b) The limited liability company does not have any debts or other liabilities, except as provided in Item 3(c);
   c) A final franchise tax return, as described by Section 23332 of the Revenue and Taxation Code, or a final annual tax return, as described by Section 17947 of the Revenue and Taxation Code, has been or will be filed with the Franchise Tax Board, as required under Part 10.2 (commencing with Section 18401) of Division 2 of the Revenue and Taxation Code.
   d) The limited liability company has not conducted any business from the time of the filing of the Articles of Organization; and
   e) Payments received by the limited liability company for interests from investors, if any, have been returned to those investors.

ASSETS (Check the applicable statement. Note: Only one box may be checked.)

4. ☐ The known assets of the limited liability company remaining after payment of, or adequately providing for, known debts and liabilities have been distributed to the persons entitled thereto.
   ☐ The limited liability company has acquired no known assets.

DISSOLUTION (Check the applicable statement. Note: Only one box may be checked.)

5. ☐ A majority of the members or managers of the limited liability company named in Item 2 has voted to dissolve the limited liability company. The undersigned constitutes a majority of the members or a majority of the managers.
   ☐ There are no members or managers. The sole person or a majority of the persons who signed the Articles of Organization of the limited liability company named in Item 2 has voted to dissolve the limited liability company. The undersigned constitutes the sole person or a majority of the persons who signed the Articles of Organization.

EXECUTION (If additional signature space is necessary, the acknowledged signature(s) may be made on an attachment to this certificate. Any attachments to this certificate are incorporated herein by this reference.)

6. I declare I am the person who executed this instrument, which execution is my act and deed.

_______________________________________ Date ______ _______________________________________
Signature of Member, Manager or Organizer — Date — Type or Print Name of Member, Manager or Organizer

_______________________________________ Date ______ _______________________________________
Signature of Member, Manager or Organizer — Date — Type or Print Name of Member, Manager or Organizer

_______________________________________ Date ______ _______________________________________
Signature of Member, Manager or Organizer — Date — Type or Print Name of Member, Manager or Organizer

RETURN TO (Enter the name and the address of the person or firm to whom a copy of the filed document should be returned.)

7. NAME

FIRM

ADDRESS

CITY/STATE/ZIP

LLC-4/8 (REV 09/2006) APPROVED BY SECRETARY OF STATE

Editor's note — If an effective date was designated in the conversion plan, the conversion is not deemed completed until after that date has passed. [Corp C §15911.04(a)(3)]

If required by a title insurer on a refinance or sale, the change of vesting to the real estate can be documented by recording a copy of the LLC-1A with the county recorder of the county where the property is located. [Corp C §15911.07(a)(1)]

A copy of the LLC-1A, certified by the Secretary of State and recorded in the county recorder's office, serves as a notice of the transfer of property ownership to the LLC. [Corp C §15911.07(c)]

Also, the LP is dissolved automatically on filing the LLC-1A, without having to file a certificate of cancellation (LP-4/8). [Corp C §15911.06(c)]

The syndication program itself remains identical after the conversion. The investors retain the same proportional interests, rights and obligations in the LLC as in the LP as long as the LLC operating agreement is a mirror image of the LP agreement.

The conversion is little more than a change in the entity's surname and the titles given co-owners of the entity. The LP becomes an LLC, the limited partners become members and the general partner becomes the manager. Property operations and tax reporting remain the same.

The significant difference is the limited liability the former general partner gains as the syndicator of the newly-formed LLC. However, the syndicator's liability limitation does not extend to his liability for debts existing before the LP was merged into the LLC. [Corp C §15911.09]

Editor's note — These rules are specifically for a California LP converting to a California LLC. For requirements of other business entity conversions, please see the DRE's Conversion Information document located at www.sos.ca.gov/business/be/forms/convchrt.pdf.

The drawbacks of conversion

The conversion from a limited partnership to an LLC does not qualify as a change of ownership that triggers **reassessment** of the partnership's property, as long as all the members retain the same proportional interests in the LLC as in the extinguished partnership. [Rev & T C §62(a)(2)]

However, the conversion of a limited partnership to an LLC is a transfer of the limited partnership's property that triggers the due-on-sale clause in any security device, such as a trust deed, encumbering the property. [12 United States Code §1701j-3(a)]

Although the **due-on-sale clause** is technically triggered by the conversion due to the automatic statutory transfer of the partnership's property to the LLC, notice to the lender is avoided if the conversion document (LLC-1A) is not recorded with the county recorder.

However, no county recording is necessary to transfer the property to the LLC. The LLC automatically succeeds to all rights and obligations of the partnership solely by filing the LLC-1A with the Secretary of State. Title to the real estate, tax billings and insurance policies can remain in the partnership's name since the LLC, even though the LLC-1A is not recorded in the county, is still the successor-in-interest to the partnership.

If the LLC-1A is not recorded, and since a grant deed to the LLC does not exists, nothing on record will indicate a transfer of the property has taken place.

Of course, in order to obtain title insurance for a refinance or sale of the property, the LLC-1A will have to be recorded with the county recorder. However, delaying the recording interferes with the lender's ability to discover the transfer and call the loan due until the property is actually sold.

Also, an LLC is not liable for its first year franchise tax if its tax year is 15 days or less and it does not do business during that tax year. Thus, the creation of an LLC and the merger should occur during the last 15 days of December. [Rev & T C §17946]

LLC-12 information statements

Within 90 days after recording an LLC-1A form with the state of California, called a *filing*, the LLC syndicator, as manager, must fill out an LLC-12 **Statement of Information** form and send it, along with a check for $20 payable to the Secretary of State, to:

Secretary of State
Statement of Information Unit
P.O. Box 944230
Sacramento, CA 94244-2300

Failure to file the LLC-12 within the 90-day period following the filing date of the LLC-1 results in a $250.00 penalty. The LLC-12 form is available online at sos.ca.gov/business/be/forms.htm. There, it can be viewed, filled out and printed from your computer for preparation prior to mailing to the state. [Corp C §§17651(b), 17653; Rev & T C §19141; see LLC-12]

In addition, every two years after filing the LLC-1 (or LLC-1A), an LLC-12R statement of information form must be mailed to the Secretary of State for filing, along with a payment of the $20.00 processing fee. The period for filing the LLC-12R is every two years during the month in which the LLC-1 (or LLC-1A) was originally filed, or in the five months preceding the original month of filing. The duty of filing the LLC-12R continues until the LLC files an LLC-4/8 form for cancellation of the LLC entity.

Cancellation of the LLC-1 (or LLC-1A)

Within 12 months after creating an LLC by filing the LLC-1 (or LLC-1A) with the Secretary of State, a syndicator may need to or want to cancel the LLC. Cancellation eliminates the LLC entirely and terminates any further assessment of the annual $800 franchise tax on the entity.

Frequently, an LLC entity is formed solely to hold title to real estate for an individual who is the true owner of the property. For federal tax reporting purposes, the LLC solely owned by one taxpayer is considered a *disregarded entity*. As a result, an individual's personal tax handling of real estate vested in his "one-man" LLC is unaffected. [26 CFR §301.7701-3]

The individual creates his one-man LLC by preparing, signing and filing the LLC-1. He takes on no co-owner, acts as the sole owner of the LLC, and does not report to the IRS, but does report to the California FTB and pay the annual California LLC franchise tax.

While the individual vests his property in the name of the LLC, he may want to retain the LLC vesting but cancel the entity to eliminate the annual franchise tax (and of course end the right of the LLC to sue or be sued and his right to limited liability for obligations of the LLC). Following the cancellation of the entity, title will remain in the LLC vesting. Bank accounts established in the name of the LLC will be retained.

If the individual needs to encumber or convey the property on a refinance or sale, the LLC-1 remains on record with the county recorder, authorizing the individual to encumber or convey real estate vested in the name of the LLC, even though it, as an entity, has been formally canceled with the state of California. Conveying is different from suing someone in the name of the LLC since maintaining a lawsuit is not permitted after cancellation of the LLC-1. However, the individual is unaffected by the cancellation and is able to sue in his own name.

Occasionally, a syndicator files an LLC-1 in anticipation of acquiring a property by forming an investment group, but is unable to close escrow and take title in the name of the LLC. The syndicator may have encountered difficulty clearing contingencies and, as a result, cancels the purchase agreement and escrow instructions. Possibly he failed to solicit sufficient commitments from investors to fund the closing.

Either way, the LLC now exists as an entity and the LLC-12 must be filed within 90 days after filing the LLC-1 or a $250 penalty is incurred. The syndicator must pay the ongoing annual $800 franchise tax as long as the LLC-1 remains uncancelled. Thus, within 12 months after filing the LLC-1, a syndicator who creates an LLC and no longer needs it, can prepare and file an LLC-4/8 form to rid himself of further liability and the continued existence of the LLC as an entity. No charge is incurred for filing an LLC-4/8. Any filing by mail should be sent Certified Mail Return Receipt Requested.

Before filing the LLC-4/8 cancellation, a final tax return must be filed with the Franchise Tax Board. However, a return does not need to be filed with the IRS if a return has not previously been filed.

Chapter 17 — Liens against individuals

This chapter explores an owner's use of a limited liability company to avoid use of the owner's name in the vesting of title to a property.

Vesting to shield assets from others

A broker/owner of a high volume real estate office with several sales agents has continuous access to real estate entering the market for sale. Occasionally the broker acquires property to own as a principal.

Due to the business activities of the sales agents employed by the broker, the broker is aware he has liability exposure for their professional errors and misconduct. Even though he has incorporated his real estate office and has errors and omissions coverage, his role as the licensed broker who qualifies the corporation for its broker's license exposes him to liability.

As the *designated officer* of the corporation, the broker bears the sole responsibility for the constant supervision of the sales agents employed by the corporation. The broker manages the office and sales agents, and occasionally meets with clients handled by agents.

The broker is cognizant of his need to personally maintain a low financial profile to avoid the appearance of a "deep pocket" which might trigger litigation. As a result, he vests all the real estate he acquires personally in limited liability companies (LLCs) he creates.

However, the broker's conflicting ownership interest between his brokerage office and any acquisitions handled in the office on behalf of his LLC vestings is fully disclosed to any seller or buyer with whom he or his corporate brokerage office or its sales agents have any relationship.

Later, an error occurs. The broker is faced with a potentially dangerous lawsuit arising out of a previous sales agent's misconduct while acting on behalf of the broker, unrelated to any of the broker's personal real estate acquisitions.

The broker needs assurance that the pending litigation, which seeks a money judgment against him personally, will not interfere with his ability to manage, sell or lease his real estate vested in the LLC.

Will a money judgment or lien against an individual member who is an owner of an LLC interfere with the real estate vested in the LLC?

No! Ultimately, only the broker's ownership interest in the LLC can be affected. Further, his interest as owner of the LLC is personal property. Thus, any liens or judgments against the broker will not affect the real estate vested in the LLC, only his interest as owner of the LLC. [Calif. Corporations Code §17300]

A lien or money judgment against an individual who is a general member, limited member, manager or member is unrelated to the real estate vested in either a membership or LLC.

Only after a judicial procedure, called a *charging order,* is processed can a money judgment against an individual attach to the individual's ownership interest as a member in an LLC. [Corp C §17302]

Interest in the LLC

An individual who is a member of an LLC has no interest in the real estate owned by the LLC. A member's ownership interest in the LLC is *personal property*. [Corp C §17300]

While a member has no interest in any LLC property, he is entitled to his share of the LLC's operating income, sales proceeds and assets should the LLC be dissolved. [Corp C §17353]

Creditors, judgments, and liens

A member in an LLC may have an outstanding debt he owes due to:

- a money judgment (i.e., lawsuit liability); or
- a local, state, or federal tax lien.

Once recorded, these money judgments or liens automatically attach to any real estate **interests vested** in the individual's name or the name of his trust.

However, a money judgment against a member which does not name the member's LLC entity as a judgment debtor can only be satisfied by foreclosing on the member's *ownership interest* in the LLC, not the real estate owned by the LLC.

Thus, a LLC entity remains unaffected by a lawsuit against a member. The entity carries on its normal business activities without interference from a member's creditor seeking to enforce its collection rights under a judgment. [Calif. Code of Civil Procedure §§708.310, 708.320]

Charging orders to attach a share

Through a money judgment against a member in an LLC, the member's **ownership interest** in the LLC may be attached to satisfy the judgment. This judicial procedure involves the use of an attachment device called a **charging order**. [CCP §708.310]

A creditor must first locate the LLC interests held by a judgment debtor. Once discovered, the creditor must apply to the court for an order to charge (lien) the ownership interest in the LLC held by the individual member for payment of the judgment. [Corp C §17302]

Notice of the hearing on the charging order must be given to the debtor member and all other members of the LLC. [CCP §708.320]

A creditor of an individual member has two options to enforce a money judgment:

- appoint a receiver to receive the debtor's share of the income and profits; or
- foreclose under the charging order lien on the member's interest in the LLC. [Corp C §17302]

Under a charging order lien, the **appointment of a receiver** is restricted to accepting the benefit of the individual member's interest in the LLC. The creditor acquires no greater rights than the debtor member had under the LLC Articles of Organization or the LLC operating agreement. [Corp C §17301(a)]

A creditor with a judgment has the judicial means to go after a member's *economic interest* only. However, the reality of obtaining an individual member's interest may be more of a hassle than it is worth. The interest the creditor obtains from the debtor member is a non-voting interest which prohibits interference with the LLC activities requiring a vote.

Further, the LLC operating agreement may provide for removal of the debtor member from the LLC if a charging order against the debtor member's interest is not immediately removed. [See **first tuesday** Form 372 §6.2(d)]

Buy-out provisions triggered

One or all of the members in a LLC may terminate a debtor member's interest in the LLC on the notice of a charging order without causing the LLC to be dissolved by:

- purchasing the debtor member's interest using assets of one or more of the other members [Corp C §17302(c)(2)];
- offering a buy-out exchange of LLC property assets (such as a specific piece of real estate) for the debtor's interest with the consent of all members [Corp C §17302(c)(3)]; or
- prior agreement under the terms of the *buy-out provisions* of the LLC agreement.

Buy-out provisions in a LLC agreement between members is the most common method used for the elimination of a member and his creditor. Additionally, the terms of buy-out provisions are usually advantageous to the remaining members.

Most buy-out provisions in LLC agreements call for the termination of the attached interest held by the debtor member. [See **first tuesday** Form 372 §7]

Fraudulent conveyances by debtors

The transfer of property by an owner of real estate to **evade a creditor** is considered fraudulent when:

- the owner actually intends to defraud his creditors [Calif. Civil Code §3439.04(a)]; or
- a reasonably **equivalent value** is not received by the owner in exchange for the property transferred and the owner is or will be insolvent (i.e., debts exceed assets) on the transfer. [CC §3439.05]

Any property transfer made for the purpose of avoiding creditors can be set aside or invalidated as a *fraudulent conveyance*. [CC §§3439 et seq.]

However, if the full value or a reasonably equivalent value is received by an owner for a transfer, the transaction cannot be invalidated. The creditor is then left to chase down and attach the proceeds received by the owner (debtor).

A fraudulent conveyance is indicated when an individual knows of pending litigation or claims then transfers his real estate without receiving fair value.

For example, an LLC consisting of three members is formed. Later, a judgment is obtained against two of the members in their individual capacities.

A creditor obtains a charging order against the members' individual interests in the LLC. All three members receive notice of the proceedings.

Prior to the enforcement of the charging order, the members act to dissolve the LLC. The two debtor members each transfer their ownership interest to the third member, who is unnamed in the judgment, for a minimal sum. The transfer is fraudulent since the third member was aware of the charging order and did not pay a fair value for the transfer.

If a transfer is made by an owner without a fair exchange of value to a "buyer" who knew the transfer would diminish the creditor's claim, the "buyer" becomes liable for the creditor's losses. [**Taylor** v. **S & M Lamp Co.** (1961) 190 CA2d 700]

Thus, the fraudulent conveyance of a debtor's "wealth" beyond the reach of a creditor will be subject to disciplinary action from the court.

Fraudulent conveyance and lis pendens

Consider a creditor who receives a money judgment against an owner of real estate vested in his name. The owner conveys his interest in the real estate by a quitclaim deed to a relative before title is liened by the creditor's abstract of judgment.

The creditor seeks to set aside the transfer as a fraudulent conveyance and records a lis pendens, which clouds the title to the property conveyed.

The relative holding title claims the lis pendens is improper and must be expunged since the fraudulent transfer claim by the creditor is an attempt to recover a money judgment, not an action affecting title to real estate.

However, the lis pendens is proper since the fraudulent transfer action concerned title to the real estate and is separate from any action to enforce the money judgment. [**Hunting World, Incorporated** v. **Superior Court** (1994) 22 CA4th 67]

The LLC asset shield

The use of an LLC to hold real estate assets was neither designed nor intended to be employed as a place to hide an individual's personal wealth. Rather, it is a means to allow real estate vested in the LLC to remain undisturbed in the face of an individual member's adversity.

Consider an owner who places his ownership of real estate into a LLC and receives a percentage or all of the ownership interests in the LLC for the conveyance.

In this instance, the conveyance is not fraudulent. The owner has merely exchanged his interest in the real estate for an interest in the LLC. Full value is received and no tax liability is incurred on the exchange. [Internal Revenue Code §721]

In essence, the owner has substituted his real estate vesting for a position in the LLC. The owner still owns a value equal to the equity in the real estate he transferred, only in a different form. Thus, the value of the owner's interest was not diminished since he received an equivalent value for the property. The nature of his ownership interest merely changes from one of real property to one of personal property.

However, this simple change in vesting inherently makes it more difficult to locate and attach the debtor's assets. The individual owner (debtor) on a recorded abstract of judgment is not the vested owner of any real estate.

Further, the change in vesting makes the real estate, now the asset of an LLC, much more difficult for the creditor to reach due to the charging order process. As the creditor is attempting to locate and attach the debtor's assets, the LLC can continue its business of renting, selling or encumbrancing the property and distributing proceeds to the judgment debtor who is now a member in the LLC.

Chapter 18 LLC membership buy outs

This chapter reviews the provisions in a limited liability company's operating agreement which allow for the buy out of one member by others.

Assigning or terminating a member's interest

Consider an investor who acquires a fractional ownership interest in a limited partnership which owns real estate. Later, the partnership is *converted* to a limited liability company (LLC) to eliminate the general partner's exposure to future liabilities. [See Chapter 16]

An LLC *operating agreement*, nearly identical to the prior partnership agreement, is entered into by all parties involved. Each investor's ownership interest in the limited partnership is **converted** to a *member's interest* in the LLC, and the general partner is given the title *manager*.

The investor now wants to sell his fractional **membership interest** in the LLC.

However, the LLC **operating agreement** restricts the **assignability** of a member's interest, as did the limited partnership agreement. This *restraint* on assignability exists to prevent the admission of outsiders who might later interfere with the LLC's investment objectives and operations.

The LLC's operating agreement permits a member to **sell and assign** his membership interest in the LLC if:

- the manager or another member of the LLC exercises his *right of first refusal* to buy and acquire the investor's interest;
- the other members **waive** their *right to terminate* a member's interest should it be sold without their approval; or
- a voting majority of the members in interest **consent** to the sale and assignment of the member's interest.

The investor first offers to sell his membership interest to the manager under the **right of first refusal** given to the manager in the LLC operating agreement.

The manager declines the offer since he is forming new investment groups to amass his own future wealth and has no interest in repurchasing or marketing fractional interests held by investors in existing investment groups. The manager would rather put investors into fresh deals which add fees and participation in ownership to the manager's portfolio.

Next, the investor offers to sell his fractional interest to other members of the LLC, who also decline.

The investor locates an outside buyer who is interested in buying his membership interest.

The other members pose no objection to the investor selling and assigning his interest and agree to *waive their right* to terminate the investor's membership interest on a sale to a buyer.

However, the other members are unwilling to also approve an assignment of the investor's membership interest and accept the buyer as a *substitute member*.

Buy-out provisions restrict assignments

By the terms of the operating agreement, a member's interest may be terminated by the remaining members if the existing member transfers his interest without the prior approval of the remaining members, unless they have *waived their right* to do so. On termination, the remaining members have the **right to buy out** the selling member's interest at what is usually an advantageous, predetermined price.

To continue with our previous example, while a waiver of termination rights allows the investor to freely dispose of his interest, the refusal of the other members to accept the investor's buyer as a member reduces the value of the investor's fractional interest.

The investor claims the LLC cannot impair his right to sell and assign his fractional membership interest in the LLC to a buyer.

However, the **assignability**, and thus marketability, of a member's interest can be controlled by the LLC operating agreement. [Calif. Corporations Code §§17301, 17303]

Thus, while the investor may assign his interest to the buyer, the assignment cannot be freely made due to the restraint on a transfer agreed to in the LLC operating agreement. Even if a waiver is obtained from the other members, an assignment does not substitute the buyer as a new member.

The remaining members must **approve** of the buyer as a *substitute member* and **release** the investor from the LLC before the **right of membership** can be transferred to the buyer. [Corp C §17303]

Consent to the assignment of a membership interest by the remaining members is accomplished by a vote of a majority in interest of the members in the LLC, unless the operating agreement calls for a different voting percentage. [Corp C §17303]

Until approved as a **substitute member**, the buyer by an assignment of the investor's interest is a *non-voting member* of the LLC. [Corp C §17301]

Assignable interests in an LLC

No member of an LLC has an ownership interest in the LLC's real estate. [Corp C §17300]

Rather, a member owns a **personal property** interest as a shareholder in the LLC which owns the real estate. [Corp C §17300]

Two **assignable interests** exist in an LLC:

- the ownership interests held by members; and
- the manager's administrative interest.

All of the fractional **ownership interests** in the LLC are held by its members only. The shares of ownership are based on the value of each member's contributions to capital, be they contributions in the form of cash (by investors) or assignment of purchase rights (by syndicators).

Figure 1 *Excerpt from **first tuesday's** Form 372 — LLC Operating Agreement*

5. **ASSIGNMENT OF INTEREST, SUBSTITUTED MEMBER:**

5.1 Assignment of Interest: A member may assign his membership interest to any other member at any time after he has first given the manager 10 days' notice to buy his interest on the same terms agreed upon with another member.

5.2 Invalid Assignment of Interest: All other assignments or transfers of members' interests are terminated according to the method under Section 6.

6. **TERMINATION OF MEMBERSHIP INTERESTS:**

6.1 Termination of Manager: The termination of the Manager does not terminate any of the Manager's rights as a member.

a. Events Causing Termination of a Member: A member may be terminated if any of the following events occur:

b. He dies, unless survived in interest by a joint tenant;

c. He is adjudged insane or incompetent, or is committed to a mental institution;

d. He transfers his interest to a non-member under Section 5.2 without obtaining prior consent from each remaining member;

e. He fails to immediately remove a charging order against his interest;

f. He files for bankruptcy;

g. He voluntarily retires, withdraws or resigns as a member;

h. He is expelled by court order or by all of the remaining members; or

i. He fails to contribute capital to the Limited Liability Company as agreed to in Section 2.1.

6.2 Notice of Termination: Service upon the member to be terminated of a written notice stating the cause for termination and the effective date of termination terminates all of his powers and his right to share in Limited Liability Company profits as of the effective date. The effective date is 30 days after service of the notice. Each remaining member shall be served under Section 13.2 both a copy of the notice of termination and a notice of the option rights held by the remaining members under Section 7.

7. **OPTION TO PURCHASE:**

7.1 Option to Purchase Upon Termination: Upon the termination of a member's interest under Section 6, the remaining members may:

a. Dissolve and liquidate the Limited Liability Company under Section 10.1; or

b. Buy the terminated member's entire interest. Where more than one member exercises his option, those exercising shall purchase their pro rata share based on their aggregate ownership interest.

7.2 Notice of Exercise of Option:

a. When a member dies, notice of the option shall be given to the deceased's representative within 120 days after the representative's appointment.

b. When a member's interest is terminated under Section 6, notice of the exercise of the option shall be given to the terminated member before the effective date of termination, and in the way a notice of termination is given under Section 6.3.

Unlike a standard member, the **manager's position** carries with it the administrative responsibility to operate the LLC and manage the real estate acquired with the capital contributed by the members. The manager is the **administrator** who oversees the day-to-day operations.

Additionally, the manager, like the president of a corporation, can be terminated and a new manager appointed at the will of the members. The **members govern** the LLC, like shareholders and directors of a corporation, since the members hold the voting rights over the *alienation* of the LLC's ownership interest in the real estate it owns.

Any capital interest also held by the manager of the LLC is vested in his name as a participating member with a percentage of ownership in the LLC. Thus, the contributing manager would be both the manager and a member.

The manager's individual membership share as a co-owner of the LLC typically arises out of his *assignment* to the LLC of his right to purchase the property which the LLC acquired, although he may have also contributed cash.

Assignee's rights to participate

The **assignment** of a member's ownership interest, with or without the approval of the other members of the LLC, does not *dissolve* the LLC. The LLC continues to operate without concern for the assignment. [Corp C §17301(a)(2)]

While the member's economic interest in the LLC is assignable, the sale and assignment of the member's interest does not automatically entitle the buyer of the fractional interest to governing rights held by a **voting member**. [Corp C §17301(a)(2)]

Without the remaining members' waiver of their **right to terminate** the selling member's interest, the selling member's assignment may result in his interest being terminated and bought out by the manager and remaining members.

If the remaining members neither buy out the interest assigned nor consent to the assignment, the buyer of the fractional interest is only entitled to an **accounting** of the distributions of income, profit or loss the selling member would have regularly received. [Corp C §17301(a)(3)]

Additionally, without acceptance as a member by a majority vote of the remaining members in interest, the buyer acquiring a member's fractional interest is not entitled to vote or participate in the governing of the LLC or exercise the rights of a member, unless the operating agreement states otherwise. [Corp C §17301(a)(2)]

Likewise, a judgment creditor of a member can *involuntarily acquire* that member's ownership interest in the LLC through a charging order and sheriff's sale of the member's fractional interest to satisfy a money judgment owed by the individual member.

However, on acquiring the fractional interest of a member at a judicially ordered sale of that interest, the foreclosing judgment creditor only receives the rights of an **assignee** as a nonvoting member of the LLC. The distributions of income, profit or loss the original member would have received are all the creditor is entitled to. [Corp C §17302]

A buyer or creditor who is assigned or forecloses on a member's interest and is not approved as a member receives only the member's **economic interest** in the LLC and assumes no duty or liability to the LLC or its other members. [Corp C §17301(b)]

AMENDMENT TO OPERATING AGREEMENT
of Limited Liability Company

DATE: _____________, 20______, at ____, California.

Items left blank or unchecked are not applicable.

FACTS:

1. This amends the Operating Agreement of ____________________________, a California Limited Liability Company,

1.1 dated _____________, 20______, at ____, California,

1.2 formed under a Certificate of Limited Liability Company (LLC-1) filed with the California Secretary of State on ____________________, ______, as document number __________________, and

1.3 recorded on ___________, _____, as document number __________________, with the county recorder of _______________________ County, California.

AGREEMENT:

The Operating Agreement of Limited Liability Company is amended as follows:

2. ____ is substituted as the new Manager in the place of ____, who is released of all rights and obligations under the Operating Agreement. The new Manager shall immediately file an LLC-2 Amendment to Certificate of Limited Liability Company with the Secretary of State and record the same with the office of the county recorder where the Limited Liability Company's real estate is located.

3. ____ is substituted as a new Member in the place of ____, who is released of all rights and obligations under the Operating Agreement. An assignment of the Member's interest is attached. [See **ft** Form 375]

4. The Limited Liability Company has acquired the ownership interest in the Limited Liability Company held by ____, who is released of all rights and obligations under the Operating Agreement. An assignment of the Member's interest is attached. [See **ft** Form 375]

5. ____ is added to the Limited Liability Company as an additional Member for the agreed capital contribution of $________________, payable in cash or ____, for a percentage ownership in the Limited Liability Company of ______%.

6. The Members agree to contribute additional capital to the Limited Liability Company in the amount of $_______________, as set forth in Exhibit "A" of the Operating Agreement – LLC [**ft** Form 372] attached to this amendment.

7. Other ____
____
____

I agree to the terms of this amendment.

☐ See attached Signature Page Addendum. [**ft** Form 251]

(Member)	(Member)	(Member)
(Member)	(Member)	(Member)

Substitute member's obligations

The buyer of a member's fractional interest may be admitted as a *substitute member* by a majority vote of the remaining members as controlled by the operating agreement. When substituted, the new member takes on all the **rights and responsibilities** of the selling member, including all capital contributions assessed against that member's fractional interest. [Corp C §17303(b)]

Additionally, on approving an assignment to a **substitute member**, the remaining members must vote to amend the LLC to substitute and release the selling member from future liability to the LLC, called a *novation*. Without a release of liability, or **novation**, the selling member remains obligated to the LLC under the operating agreement he originally entered into. [Corp C §17303(c); see Form 374 accompanying this chapter]

*Editor's note — After he has transferred his interest, the selling member cannot later interfere with the LLC's objectives. The selling member's withdrawal does not release him from all obligations owed to the remaining members. A **fiduciary** duty among members still remains in regard to investment opportunities and operations which are known to the released member and are of value to the LLC. [**Leff** v. **Gunter** (1983) 33 C3d 508]*

The same fiduciary duty is owed to the LLC by the substitute member who becomes a voting member.

Documenting the transfer

An *assignment* of a withdrawing member's interest and *substitution* of the buyer as a new member are completed by:

- a written **assignment** from the withdrawing member to the buyer; and
- an **amendment** to the operating agreement by a vote of the remaining members.

With an **assignment**, the withdrawing member transfers all his right, title and interest in LLC to the buyer who is acquiring his fractional interest. [See Form 374]

If the remaining members elect to accept the buyer as a substitute member, the operating agreement is **amended** to *substitute* the new member (buyer) for the withdrawing member. [See Form 375 accompanying this chapter]

For the amendment to be effective on the substitution of a member, it must be signed by the remaining members holding the percentage of ownership interest called for in the operating agreement, usually a super-majority (e.g., 75%).

Should the operating agreement not state the percentage of ownership interest required to consent to a substitute member, then a majority in interest of the members must sign the amendment. [Corp C §17303(a)]

The LLC does not need to prepare and file an Limited Liability Company Certificate of Amendment (LLC-2) on the assignment of a member's interest. [See FTB Form LLC-2]

However, when admitted to the LLC as a substitute member, the substitute member's name must be added to the list of current members which is required to be kept at the LLC office maintained by the manager. [Corp C §17100(b)]

ASSIGNMENT OF INTEREST
In Limited Liability Company

DATE: _____________, 20______, at ____, California.

Items left blank or unchecked are not applicable.

FACTS:

1. This assignment is of a member's interest in ___________________, a California Limited Liability Company (LLC), organized under an operating agreement dated _____________, 20______, at _____________________, California, and formed under a Certificate of Limited Liability Company (LLC-1)

1.1 filed with the California Secretary of State on _____________, as document number _______________,

1.2 recorded on _______________________________20______, as document number _________________ with the county recorder of __________________________ County, California.

FOR VALUE RECEIVED:

2. I, ____, as the Assignor, hereby sell, assign and transfer to ____, as the Assignee, all my rights, title and interest as a member in ____, a California LLC,

2.1 which interest is identified as Class "______" and represents ______% of the voting ownership of the LLC, and

☐ is represented by the attached Certificate of Interest in Limited Liability Company (if one exists).

3. Assignor hearby authorizes ____, as the Manager of the LLC, to reflect this assignment on the books of the LLC.

4. This assignment is subject to any restrictions on the transfer of an ownership interest provided in the Operating Agreement of LLC for the LLC.

4.1 Any necessary notices and approval of this assignment by the LLC or members and any right of first refusal or option to purchase the interest assigned held by the remaining members ☐ have, or ☐ have not, been consented to or waived by them.

5. Assignee hereby assumes and agrees to timely perform all Assignor's obligations under the operating agreement of the LLC.

Assignor:	**Assignee:**
☐ See attached Signature Page Addendum. [**ft** Form 251]	☐ See attached Signature Page Addendum. [**ft** Form 251]
Date: _____________, 20______	Date: _____________, 20______
Signature: _____________________________________	Signature: _____________________________________
Signature: _____________________________________	Signature: _____________________________________

FORM 375 02-08

Manager's assignments

The assignment of an LLC's manager's interest is more complex than the **assignment of a member's interest**. It is accomplished by:

- a written assignment by the manager or notice of termination by the members;
- a vote amending the operating agreement to identify the new (substituted) manager; and
- a filing with the Secretary of State and recording with the county recorder of n LLC-2 form naming the substitute manager. [Corp C §17054(c)(2)]

The withdrawing manager's interest is assigned to a substitute manager and the operating agreement is amended by preparing the same documents used to substitute members. [See Forms 374 and 375]

Whenever a manager is substituted or removed, the LLC must notify the Secretary of State of the change by filing the LLC-2. [Corp C §17054(c)(2)]

An LLC-2 is a government form issued by the Secretary of State's office to amend or correct the Limited Liability Company Articles of Organization (LLC-1) which is on file with the Secretary of State. [See LLC-2]

After the LLC-2 is filed with the Secretary of State, the prior manager's authority to act on behalf of the LLC is terminated by recording the LLC-2 in the county where the LLC's real estate is located. [Corp C §17052(f)]

Due-on and reassessment

Two further consequences must be considered when assigning a selling member's fractional interest in an LLC.

First, the rights of trust deed lenders to call on a transfer should be considered. The manager and remaining members must review each provision in the trust deeds encumbering the real estate owned by the LLC for the existence of a *due-on clause* since the buy out of a co-owner's fractional interest may trigger the lender's **right to call or recast** the terms of the loan.

If a **due-on clause** exists which contains wording relating to the transfer of fractional ownership interests in the entity vested in title, the clause may be triggered by the assignment. The remaining members must then decide whether to notify the lender of the "off-record" buy out.

Second, the remaining members must ascertain whether the assignment of the selling member's interest is classified as a **change in ownership** which would trigger *reassessment* by the county assessor and result in higher property taxes.

The transfer of 50% or less of the ownership interests held by members during the life of the LLC does not constitute a change in ownership and does not trigger reassessment of real estate vested in the name of the LLC. Conversely, the transfer by members of more than 50% of the member's ownership of the LLC does trigger reassessment of the LLC's property. [Calif. Revenue and Taxation Code §64(a)]

Additionally, when a member with a minority interest in an LLC acquires enough ownership interests to hold a majority interest (more than 50%), a *change of ownership* occurs, triggering reassessment of the entire parcel of real estate owned by the LLC. [Rev & T C §64(c)(1)]

An LLC manager must sign and submit a change of ownership statement to the State Board of Equalization (SBOE) within 45 days of the earlier of the 50% change in ownership or SBOE request for the statement. Failure to timely file the change of ownership statement results in a penalty of 10% of the taxes due on the new full cash value of the change in control of real estate owned by the LLC. [Rev & TC §482(b)]

Membership vesting is estate planning

Vesting co-owned real estate in an LLC instead of as tenants in common eliminates any interference with title to the real estate on the death of an LLC member (and provides limited liability for members and the manager).

By filing the LLC-1 (or LLC-1A), entering into an operating agreement to create an LLC and vesting real estate in the name of the LLC, the death of a member (co-owner) does not create chaos for the management of the real estate. This is in contrast to what occurs on the death of a co-owner when he is vested on title as a tenant in common.

The membership interest held in the LLC by a deceased member is transferred on or after death according to how he vested his ownership interest, similar to a transfer of real estate interest on death.

Six **types of vestings** are available for ownership interests held by individuals in real estate or personal property (shares in the LLC) located in California:

- joint tenancy;
- community property;
- community property with right of survivorship;
- tenancy in common;
- sole and separate ownership (single, unmarried, spouse); and
- revocable living (inter vivos) trusts or other title holding arrangements.

Vesting not only provides evidence of the ownership of an interest in property, vesting is a method of estate planning since it states the nature of the ownership (community or separate) and intended distribution of the interest on the owner's death (by the right of survivorship, will or trust).

Two or more individuals may vest the percentage of LLC membership interest they jointly own in "joint tenancy," such as "husband and wife as to a 20% interest, as joint tenants."

On the death of one of the joint tenant members, the surviving joint tenant who co-owned the interest with the deceased automatically succeeds as owner to the entire membership interest they had jointly held in the LLC.

The **sole advantage** of a joint tenancy vesting for a co-owned interest is the avoidance of probate. The same results occur when the husband and wife vest their co-ownership as community property with the right of survivorship.

Managing a deceased member's interest

When an LLC member dies, the member's legal representative, such as an executor, administrator or trustee, may exercise all of the member's rights in the LLC for the purpose of administering and securing the deceased member's estate. [Corp C §17304(a)]

LLC operating agreements typically include provisions allowing the remaining members to **terminate a member's interest** upon his death, unless the deceased member's interest is held by a surviving joint tenant who co-owned the interest with the deceased.

Thus, the remaining members can purchase the deceased member's terminated interest under the buy/sell provisions in the LLC operating agreement.

If the option to buy out the deceased member's interest is not exercised, the remaining members are under no obligation to approve the deceased's legal representative as a new member of the LLC. If they do not, the representative or any other successor of the deceased's interest may not vote or become involved in the governing of the LLC or the manager's administration of the LLC and its property.

Chapter 19 Documenting the LLC investment program

This chapter introduces the documentation needed to solicit funds, form and manage a limited liability company to own and operate income-producing real estate.

Birth and expectations of an LLC

The formation and funding of a limited liability company (LLC) requires four documents — two to form the LLC itself and two to solicit investors to fund the LLC.

The documents needed to form an LLC include:

- the LLC-1 **Articles of Organization** form (or the LLC-1A if the LLC was created in a conversion from an LP), the LLC law counterpart to the LP-1 for a limited partnership, issued by the California Secretary of State for use by the syndicator to establish and operate an LLC in California [See Chapter 16]; and

- the **operating agreement**, similar to most co-ownership agreements in its management, income- and profit-sharing, voting and buy-out provisions. [See **first tuesday** Form 372]

The funding documents include:

- the **investment circular**, a narrative disclosing all the material aspects of the investment to prospective co-owners, prepared as the product of the syndicator's due diligence investigation and analysis of the property [See **first tuesday** Form 371]; and

- the **subscription agreement**, the investor's agreement with the syndicator to contribute funds in exchange for an ownership share in the LLC. [See **first tuesday** Form 373]

The articles of organization

By stating the syndicator is the sole manager, the articles of organization (LLC-1) gives the syndicator the **power to bind** the LLC by entering into agreements following a vote by the members to buy, sell, finance and lease property, or to contract for management, services, labor and materials to operate the real estate acquired by the LLC. [Calif. Corporations Code §17157; see Chapter 20]

The operating agreement

The document that authorizes the operations of the LLC is the **operating agreement**. It also states the rights and duties of the syndicator, as manager, and the co-owners.

The operating agreement for an LLC must contain all the fundamental boilerplate provisions that lay out the working relationships between the syndicator and the co-owners. Provisions include profit-sharing and buy-out arrangements, comparable to those used in any other co-ownership agreement, such as limited partnership, tenants in common (TIC), and stockholder co-ownership agreements.

The operating agreement is signed by all investors at the same time they sign the subscription agreement agreeing to invest.

A written operating agreement is not required to evidence the agreement between the co-owners and the syndicator forming an LLC. However, it is prudent to form a group investment program based on a written operating agreement, not an oral one. [See **first tuesday** Form 372]

The governing principles for the ongoing operations and co-ownership in the LLC as stated in the operating agreement include:

- business purposes and objectives;
- capital contributions and percentage ownership;
- co-owners' participation in the distribution of income and profit from operations, financing, and sale;
- establishment of different classes of members (i.e., Class A membership shares granting priority distributions to cash investors and Class B membership shares granting a subordinated right to earnings held by the syndicator);
- officers, management, compensation and accounting; and
- assignment of interests, termination of a co-owner and buy-out options; and
- dissolution and termination of the LLC.

The operating agreement designates the syndicator as the manager of the LLC. As the manager, the syndicator may give himself any title he wants to use, such as president, chief executive officer (CEO) or general manager. As the lone manager, he is solely responsible for conducting the business affairs of the LLC.

In addition to the manager, the operating agreement may provide for the appointment of other officers, such as a secretary, treasurer and so on, as in a corporate management structure. The officers do not need to be co-owners. For instance, an accountant who is not a co-owner could be named as treasurer should the syndicator deem the position is appropriate to provide oversight for the cash flow from the investment program. [Corp C §17154(a)]

The operating agreement for an LLC is fundamentally a **profit-sharing agreement**. It spells out when and how all the co-owners will participate in the rents and profits generated by the property acquired with the funds they invested in the LLC.

To best understand the nature of the earnings generated for the co-owners by their investment in the LLC, a return **on** capital must be distinguished from a return **of** capital.

The **return on capital** is the ongoing, annual net earnings from rents generated by the operation of an income-producing property. Return on capital takes the form of some or all of the spendable income.

The return from operating the property is generally expressed in terms of an annual percentage yield based on the co-owners' original cash contributions. The classic example of a return on capital is the interest paid on a savings account. In real estate investments, it is that portion of the rents paid by tenants that remains after paying expenses and interest on borrowed capital.

Conversely, the **return of capital** is simply the return to the investors of the funds they originally contributed. In the case of a real estate investment, the return of capital includes that portion of the loan

reduction and spendable income sheltered from taxes by the annual depreciation deduction, as well as the net proceeds from a refinance or resale of the property — up to the amount of the original contributions.

Profits taken by a refinance or sale are the result of capital growth due primarily to dollar inflation and property appreciation. While profits are a return on capital, they are not a return from operations (annual income) or a return of the original capital investment.

The investment circular for solicitation

The **investment circular**, also known as a *prospectus* or *memorandum*, is prepared by the syndicator. He uses it to solicit prospective investors to buy a share ownership in his LLC investment program.

The purpose of the investment circular is to present investors with the material facts about the investment opportunity, giving as much breadth in scope and as much detail as is necessary for a prudent investor to be able to make a well-informed decision based on a review of its content. [See Chapter 20]

Information provided in the investment circular includes:

- the business and investment objectives of the LLC;
- a full description of the property to be purchased, including the condition of the improvements, natural and man-made (environmental) hazards, location, title and operation of the property;
- the proposed operating budget of the LLC;
- projected earnings for co-owners;
- a disclosure of the risks of loss involved;
- the background and qualifications of the syndicator;
- the compensation and duties of the syndicator as manager of the LLC; and
- copies of the LLC-1 articles, operating agreement and subscription agreement.

Generally, the syndicator will hand the investment circular to prospective investors to induce them to contribute funds to the LLC at a non-negotiable, set price for participating as a co-owner member.

The commitment to subscribe

An investor fills out the **subscription agreement** he has received with the investment circular. He signs it and returns it to the syndicator, committing himself to contribute funds as a member of the LLC.

The subscription agreement is broken down into three parts:

- the investor's offer to contribute funds to the LLC;
- the investor's acknowledgment of his receipt and review of the syndicator's transactional disclosures and declarations made in the investment circular; and

- the investor's income and net worth disclosures made to the syndicator for a determination as to whether the investor is a suitable candidate for co-ownership in the LLC.

Editor's note — "Certificates of interest" may be issued to the co-owners to evidence their ownership of a share in the LLC, but the shares in the LLC must not be called ***stock****. Any transaction or investment program that involves the issuance of shares entitled stock is automatically considered a corporate security, regardless of whether the economic realities of the transaction include a risk of loss of the promotional reliance variety that constitutes a corporate security. [****Landreth Timber Company*** *v.* ***Landreth*** *(1985) 471 US 681]*

Also, by signing the subscription agreement, the investor indicates he understands the nature and risks inherent in the LLC investment program as disclosed by the syndicator in the investment circular.

Finally, the investor provides general information on his net worth and income along with other relevant matters such as prior investment experience and educational background. Since the investors are entitled to receive detailed information on the syndicator, the syndicator presents his profile in the investment circular.

Before accepting any investor's offer to become a co-owner, the syndicator uses the information provided in the subscription agreement to determine the LLC investment program's financial suitability for the investor.

After reviewing the investor's subscription agreement offer to invest and his credentials, the syndicator accepts the investor's offer to buy a fractional interest by signing a copy of the agreement and returning it to the investor.

Power of attorney authority

Operating agreements for LLC investment programs consisting of a large group of investors often call for the members to give the manager a **power of attorney**. This authority allows the manager to act on behalf of the co-owners to exercise their voting rights under the LLC operating agreement.

A power of attorney is a written document separate from the operating agreement. It is entered into by an individual member, granting another person — the manager — the authority to enter into agreements and act on the individual's behalf. [Calif. Probate Code §4022; see **first tuesday** Form 447]

Granting the manager a power of attorney to act on behalf of an investor is not necessary when forming an LLC. Typically, the investor will sign all documents requiring his signature at one time, including the subscription agreement to invest, the operating agreement and his check to fund his contribution.

However, the power of attorney may be useful when activities of the LLC must be approved by the co-owners under the voting provisions in the operating agreement, such as voting to admit a new or substitute co-owner, or to continue the LLC after an event occurs causing dissolution.

The power of attorney should not be used to eliminate the need for co-owners to approve significant non-recurring ownership events, such as the *alienation of property rights*. Authority to alienate would allow the syndicator to reorganize the investment (through a refinance or exchange of properties), a transfer of possession by entering into a long-term lease or the disposition (sale) of all or part of the investment property.

Thus, the scope of the authority granted to the manager under any power of attorney should be limited to the short-term, on-going operation of the LLC and the property. For example, the power of attorney might properly authorize the manager to vote on the co-owners' behalf to continue the LLC after a dissolution, but not to amend the operating agreement or refinance or sell the LLC's real estate.

Chapter 20 — A checklist for an investment circular

This chapter reviews the material facts to be considered for inclusion in documentation used for soliciting investors to fund the purchase of property.

An agency duty to disclose

An **investment circular** (IC) is a disclosure prepared by the syndicator and presented in pamphlet form to potential cash investors. The purpose of the IC is to explain to the investor, as fully and clearly as possible:

- the nature of the investment program;
- the significant features and aspects of the property to be acquired; and
- the risks and financial consequences of the investment.

The more information provided by the IC, the more effective the syndicator's demonstration of the thoroughness of his research of properties, due diligence investigations and analysis of the property's worth as an income-producing asset with long-term profit potential.

A well-organized and comprehensive review of the selected property's attributes in an IC gives the prospective investor information on:

- the property's physical condition;
- its operating history of income and expenses;
- a forecast of its future operations under the syndicator's management;
- title conditions;
- conditions affecting the property due to its location and the surrounding neighborhood; and
- the rental competition and resale market trends.

Goals of an investment circular

The IC must be readable and visually attractive to a prospective investor. The information contained in an IC must allow a prospective investor to move effortlessly from page to page. The copy needs to have an open feeling, be clean in appearance and contain short sentences and paragraphs.

A syndicator creating an IC must avoid using encoded real estate lingo and legal terms which are not easily comprehensible to a layperson. Instead, use words of plain meaning and in common use that are easily understood and absorbed. If the copy puts the reader off, he will not carry through to contribute cash to the investment.

An IC is presented in a chronological manner, instructive and reasonable in its conclusion and worded as a vivid presentation of the investment program. Then, in response to any question a prospective investor poses, a mutual review of relevant sections of the IC will contain the answer.

An investment program which seeks to acquire and operate property for the same purpose the property is currently serving (such as the acquisition of an existing income-producing property acquired to be operated as a rental property), does not contain a corporate securities risk. Thus, the co-ownership operation of the property contains no risk of loss beyond the economic risks imposed on all landlords, tenants, sellers and buyers in the marketplace.

Marketplace risks do not come within the purview of the securities laws. They are controlled by the laws of economics. Without the presence of a risk of loss such as the need to rehabilitate the property for the rental market, to change its use (such as through subdivision for resale, development or construction) or to change the zoning or obtain a conditional use permit, the investment program is not a security and does not fall within the securities law controlling the solicitation of investors to contribute. [See Chapter 14]

Also, any method or means used to locate and solicit investors to join the co-ownership of real estate does not of itself present a risk of loss within the securities law, and does not turn a non-security into a security. Advertising to solicit investors does not create a securities risk.

In contrast, the use of the IC to market a real estate investment opportunity that includes the inherent risk of loss present in a securities risk requires some rewording and additional provisions in the LLC operating agreement and IC, such as the business purpose and future contributions provisions. The transaction that includes a securities risk, such as a conversion to condominiums, construction of improvements, or other change-of-use activity that adds value to the property by the efforts of persons other than the investor, falls within the control of the securities law.

When the investment program is controlled by the securities law, exemptions are available that allow the nonpublic solicitation of investors. If not exempt, a securities permit must be obtained to publicly solicit investors. Whether the transaction is or is not a security, to be devoid of deceit the syndicator still must provide a full disclosure of the investment program — the primary purpose of an IC.

Further, if a securities risk exists, the solicitation of investors under the *nonpublic offering exemption* does not allow any information about the availability of the investment to be published as an **advertisement to the general public**. [See Chapter 14]

The syndicator's duty to prepare and present an IC to each prospective investor for a syndicated real estate investment program is imposed by agency law. A syndicator must, due to his **agency relationship** with all prospective investors, make a full disclosure of all material facts since they affect the value of the property and relationships between investors.

The duty to disclose goes far beyond a listing agent's duty owed to a buyer when presenting a marketing package on a property he has for sale. The syndicator's agency duty is to care for and protect the prospective investors, and provide the information they need to make a decision whether to invest. Thus, the IC is the best method for making the disclosures and documenting that they have been made.

Land investments

The operating agreement for an limited liability company (LLC) formed to invest in undeveloped land for later resale must contain a clause allowing the syndicator to call for and collect periodic future con-

tributions from the co-owners to pay the carrying costs of owning the property, such as loan installments, taxes, and insurance.

Also, no spendable income is expected from the acquisition and ownership of unimproved real estate, only a profit on resale. Accordingly, the wording regarding the distribution of expected earnings and profits in the IC and operating agreement must be redrafted.

Trust deed investments

For an LLC investing in trust deeds, the purpose clause in the operating agreement is modified to state the LLC is being formed to purchase a particular note secured by specific real estate, rather than to purchase the real estate itself.

Also modified is the spendable income clause, since distributable income in a trust deed investment is not generated by the operations of rental property, but by interest paid on the note (unless the LLC is later forced to foreclose and becomes the owner-operator of the real estate securing the note).

If the note is secured by income-producing property, the trust deed IC will include much of the same real estate disclosures made for an investment in income-producing property. Thus, a trust deed IC requires additional disclosures. [See Chapter 19]

The IC discloses the condition of the note to be acquired — the loan-to-value ratio (LTV), the trust deed's priority on title, terms of payment, payment history, interest rate, due date, borrower's creditworthiness and so on.

Also, the IC must disclose the special risks of trust deed investments, such as the possibility of foreclosure and ownership of the real estate due to a default.

Finally, ownership of a trust deed investment, whether structured as an LLC or a tenancy in common (TIC), is classified as a security. Thus, as an LLC investment in a trust deed, the nonpublic offering exemption (or a permit) must be obtained. If structured as a TIC ownership by investors, a notice permit on a claim of exemption allowing public soliciting of investors is available to syndicators.

Checklist for the investment circular

The investment circular states the name and business address of the LLC, identifies the syndicator, explains the objectives and risks of the investment program and includes major documentation.

Introduction to the investment circular

This investment circular (IC) checklist is designed to help the syndicator of an LLC investment program fulfill his agency duty owed to prospective investors. He must disclose all factors affecting an investment in an existing, fixed asset with a present value at least equal to the price paid for the property. The securities risks existing in a controlled investment must be included in this checklist for analysis and full disclosure in an IC prepared for such an investment.

Editor's note — The bold-faced items in the checklist represent headings in the table of contents for the investment circular. The indented items in the checklist are to be considered for inclusion under each heading.

Investment objectives and policies

- A return of capital, income, profits or losses that will result from the operation and eventual resale of the property
- Co-owners will participate in the benefits of group ownership of the real estate, but will not be responsible for day-to-day management

Summary of property purchase and financing

- Purchase agreement
- Terms of the agreement
- Vesting of the real estate
- Contingencies and options
- Investors' funds returned if the LLC is not fully subscribed
- Title insurance
- Liability and hazard insurance
- Property taxes
- Seller's name, address, and relationship to the syndicator
- Terms of financing
- Fee appraisal report

Capitalization of the LLC

- Total cash to be raised
- Number of shares offered for investment and dollar amount of each
- Syndicator exchanges purchase rights for Class B membership
- Additional contributions if the investment property is undeveloped land or a negative cash flow income property

Use of the contribution proceeds

- Cash down payment on purchase price
- Acquisition and organizational expenses
- Reimbursement of syndicator for funds advanced
- Fee for syndicator's organizational services
- Reserve funds

Risk factors

- All group investments involve a degree of risk

- The co-owners' ability to transfer their interests in the LLC is restricted
- Assignment of a majority of shares triggers reassessment and a change in property tax
- Changes in economic conditions will affect income and profits
- Treatment of income and losses from operations or sale for co-owner tax reporting is subject to federal and state tax codes and regulations
- Co-owners might default on their obligation to contribute capital
- Disclosure of the manager's interest in competing properties [See Chapter 6]

Description of the real estate

- Fee simple/leasehold
- Location
- Present use, zoning, rent control and use restrictions
- Acreage/square footage
- Condition of improvements, building inspection report
- Environmental hazards report
- Natural hazards report
- Neighborhood surrounding the property
- Criminal activity and personal security aspects

Compensation of the manager

- Disclosure of earnings and profits from the property
- Fee on yield spread premium (YSP) received for arranging the purchase-assist financing
- Commissions paid by seller on acquisition
- Ownership interest held as a member
- Monthly property management fee
- Fee on refinance or resale of the property
- Beneficial interest in real estate financing
- Relationship to the seller

Operation and management of the property

- Property management agreement
- Management fee
- Bank accounts
- Manager's fidelity bond
- Statement of manager's qualifications
- Operating history of the improvements

- Anticipated future operating performance, as referenced in the annual property operating data (APOD) form
- Anticipated distributions to co-owners
- Priority and subordinated interests
- CPA audits

Qualification of syndicator

- Describe the educational and business background of the syndicator, and previous experience in acquisition, sales property management and real estate syndication

The LLC operating agreement

- Terms of the operating agreement
- Restrictions on the alienation rights of members
- Death or withdrawal of a co-owner
- Distribution of earnings
- Management provisions
- Additional assessments on co-owners to cover taxes, insurance, loan payments, etc.
- Power of attorney held by manager

Reports to investors

- Reports on acquisition of property
- Copies of LLC formation and operating documents
- Copy of title insurance policy
- Closing statement
- Balance sheet
- Annual reports

Other reports

- Annual report to Secretary of State (LLC-12)
- Annual tax information, allocation of income and expenses
- Availability of fee appraisal report
- Existing litigation in which the syndicator or the property is presently involved

Federal income tax consequences

- LLC reports to tax agencies
- Taxation of co-owners' interest
- Opinions of advisors
- Attorney and CPA for LLC [See Chapter 7]

- Tax opinions
- Aspects of an LLC
- Description and explanation of LLC entity
- All co-owners' liability limited to amount of contribution
- Partnership or TIC tax treatment
- Minimum California franchise tax
- Agent for service of process
- One year statute of limitations for unanticipated securities violations

Exhibits

- Articles of Organization (LLC-1)
- Operating agreement
- Subscription agreement
- Opinion of counsel
- APOD for rental property
- Preliminary title insurance report
- Plat map of property

Chapter 21 The investment circular

This chapter presents the entire contents of a typical investment circular as prepared by a syndicator for solicitation of investors to contribute and become members of a limited liability company. An editable version of the investment circular, ***first tuesday*** *Form 371-1, is available online at firsttuesday.us and on the Forms-on-CD.*

INVESTMENT CIRCULAR

Dated: ____________________________, 20__________

To: ____

From: ____, the Manager of

____, LLC,

a California Limited Liability Company.

Re: Investors with $ _______________________ cash available for placement in an income-producing real estate investment program.

You are kindly requested to consider this investment opportunity.

$____________________ cash will be raised for a down payment, closing costs, and reserve funds to purchase income-producing real estate.

The property to be acquired is a(n) _________________________________ building located at ____, in ___________________________________ California.

The purchase price of this income property is $____________________.

The mortgage financing on the property is the total principal amount of $____________________.

Group ownership of this property will create the following advantages for the investors:

1. A high-yield priority return on invested funds from spendable income, equity build-up, and increase in property value;
2. No additional capital contribution;
3. Management of the property and accounting to be handled by the LLC manager; and
4. Individual co-owner tax benefits.

Please review the specially prepared investment circular accompanying this letter for the details of these and other advantages.

My deadline for funding the close of the purchase escrow is ___________________, 20______.

Please call me at ________________________ if you desire any further information.

Sincerely,

____

INVESTMENT OPPORTUNITY

___________________________________, LLC,

a California Limited Liability Company,

offers investors a

$__________________________ cash

investment program

consisting of ______________________

$______________________ Class A membership units

in the ownership of

income-producing real estate

valued at $_______________________

This Investment Circular is dated: _____________________________, 20______

INVESTMENT CIRCULAR

Presented by ____, LLC,

a California Limited Liability Company
Offering Class "A" investment units at
$____________________ per unit.

The investment program is designed to raise cash in the sum of $____________________, for use by the Limited Liability Company (LLC) to acquire and operate, as a long-term investment, an existing income-producing _______________________________ property. The investment is designed to deliver to the investor:

- spendable income;
- equity build-up by monthly amortized loan reduction;
- an inflationary hedge and appreciation in value;
- tax benefits of annual depreciation deductions;
- minimum management requirements;
- priority distribution of income and profits;
- liability limited to capital invested; and
- debt leveraged ownership serviced by rental income.

The investment program is limited to investors meeting minimum financial and suitability standards.

Other than filing articles of organization for the LLC, this investment program has not been qualified or registered with any governmental agency, as no qualification or registration is required by law. No permits of any kind have been sought or received prior to offering this investment program to prospective investors.

INVESTMENT CIRCULAR SUMMARY

____, LLC, a California Limited Liability Company, offers _______________________________ investment units of $______________________ each, as a long-term investment program involving a degree of risk.

The LLC is newly organized and has no operating history. It holds the contract rights to purchase income-producing real estate commonly referred to as ____, in the City of _____________________________, ______________________________County, California. The property current fair market value is $_____________________.

The LLC shall hold title to the property subject to a loan(s) totaling $_____________________. The purpose of this offering is to raise capital funds for the down payment on the purchase of the income-producing real estate, pay an organizational fee to the manager and establish a reserve fund.

The material set forth in this circular is a presentation of this investment program and solicitation of investors. In the investment circular, the Manager has set out all available material facts and data for presentation to prospective investors.

This investment does contain risk factors, as it is more speculative than insured interest-bearing accounts or real estate owned clear of any mortgage financing.

The investors' interests in this LLC will not be acquired with the intent to resell. The interests offered will be difficult to market or resell, and liquidation of any individual member's interest will likely result only from resale of the property by the Manager. [See Section 6, Risk Factors]

The units offered may be subscribed to by investors who meet financial and suitability standards, and who are sufficiently well informed in real estate investments to discern for themselves the risks inherent in the offering.

If for any reason the subscription of sufficient investors fails to be completed by ____________, 20_____, the investor's funds will be returned in full without reduction in amount, together with any interest earned thereon.

The minimum financial suitability standards set by the Manager for this investment program require investors to have a minimum adjusted gross income of $_______________ and a net worth of $______________, exclusive of personal residence, automobile, and personal property. The intention to purchase and hold a membership share in the LLC for long-term investment purposes rather than for resale is also a necessary requisite.

The Class A membership interests offered have not been registered with the Securities Exchange Commission (SEC) nor qualified with the California Department of Corporations (DOC), and no permits have been obtained from any governmental agency. This investment program is to capitalize the purchase and ownership of an existing asset, to be held for income from rents and profit on resale. No future improvement or development of any kind to create or complete this investment is anticipated, and the investment requires no reporting under any securities laws, state or federal.

INVESTMENT CIRCULAR

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SECTIONS: **Page**

EXHIBITS:

ADDENDA:

____, LLC,
a new California Limited Liability Company
formed for a group of investors
to acquire a(n) ____ building
located in____________________, California.

SECTION 1. INVESTMENT OBJECTIVES AND POLICIES

The Limited Liability Company (LLC) will purchase and operate, for long-term investment advantages, an existing ____, located at ____________________________________, in __________________________, California. The project is more commonly referred to as____.

The objectives of the LLC are to provide Class A members with:

- spendable income;
- equity build-up by monthly amortized loan reduction;
- an inflationary hedge and appreciation in value;
- tax benefits of annual depreciation deductions;
- minimum management requirements;
- priority distribution of income and profits;
- liability limited to capital invested; and
- debt leveraged ownership serviced by rental income.

Local and national conditions should allow the LLC to attain all these objectives. However, there can be no assurance these objectives will be fully attained.

The Manager will direct the acquisition of the real estate. Income, profits and return of invested capital from the LLC property will be the result of spendable income generated by property operations, proceeds of refinance or resale of the property, and annual tax benefits, in any.

The Manager will diligently conduct the affairs of the LLC to achieve these investment objectives.

Information presented in this investment circular is intended to provide a prospective investor with sufficient facts concerning the proposed investment to make an informed decision to invest. Estimates of income and expenses incurred by the LLC are based on existing facts and the best estimates of the manager and his advisors, and are not intended as guarantees or warranties to the investor.

Any real estate investment is speculative in nature and includes some degree of risk. It is suggested that a prospective investor contact his accountant, attorney or investment counselor for additional advice concerning this investment's suitability.

SECTION 2. SUMMARY OF PROPERTY PURCHASE

A contract to purchase the real estate has been entered into by ________________________________, an individual, as the Buyer. These purchase rights will be assigned to the LLC for its acquisition of the property prior to closing, in exchange for Class B membership interests valued at $______________.

The Seller, who has contracted to sell the property, is ____. The purchase contract is dated ______________________________, 20______. An escrow has been opened with _________________________________, escrow number _________________________, dated ____________________, 20______.

The purchase contract and escrow instructions are attached to this investment circular as Exhibits "A" and "B". These documents are the only purchase contracts involved in this transaction.

The terms of the purchase price are:

Cash down payment	$______________
Existing debt taken over	$______________
New loan to record	$______________
Note carried back by Seller	$______________
TOTAL Purchase Price	$______________

The amount of the cash down payment includes the return to the Manager of his deposit toward the down payment on the purchase price.

The purchase price is not the total cost to the LLC to acquire the property. Pro rations and adjustments for the Landlord/Tenant obligations are also included, as well as transactional closing costs. A completed Buyer's Cost Sheet for acquisition of the property by the LLC is set forth in Exhibit "D".

SECTION 3. REAL ESTATE FINANCING

The financing, its balance, interest rates, monthly payments, due dates and other facts are as follows:

The first trust deed encumbrance secures a note in the remaining balance of $______________, payable $______________ monthly, including interest at the rate of _______%, until paid _________________.

The seller's carryback note, secured by a second trust deed on the property, is in the amount of $______________, payable $_________________ monthly, including interest at the annual rate of ______%, all due and payable on ______________ 20______, with a final/balloon payment of $______________.

SECTION 4. CAPITALIZATION OF THE LIMITED LIABILITY COMPANY

The amount of capital to be raised by cash contributions from prospective investors is $______________. To obtain this amount, _________ Class A units at $______________ per unit are offered to investors.

Each subscribing investor may purchase a minimum of ______ units and a maximum of _____ units. Subscriptions are to be accompanied by full payment.

Should the total amount of capital to be raised not be received prior to the cancellation of the purchase escrow on the real estate, or ______________________________, 20_____ if sooner, the subscription will terminate and all funds received from prospective investors will be returned promptly with any interest earned.

SECTION 5. USE OF THE CONTRIBUTION PROCEEDS

The capital cash contributions of $______________ from investors with Class A interests will be deposited and disbursed as follows:

1. $______________ shall be deposited in escrow as the additional funds required to close the real estate purchase.
2. $______________ shall be disbursed to the Manager to reimburse him for his cash deposit in escrow toward the down payment on the purchase price.
3. $______________ shall be disbursed to the Manager as an organizational fee.
4. $______________, approximately, will be deposited with any other funds remaining in the LLC bank account as a reserve fund to be used by the Manager at his discretion for expenditures which were or will be incurred for the organization of the LLC and the acquisition of the property, including costs related to a title search.

SECTION 6. RISK FACTORS

An investment in the Class A units offered involves some risk of loss of the capital invested. Potential investors are to carefully consider each of the following factors.

A. LLC Operations

This LLC is newly organized and has no operational history. The Manager will devote to the LLC's affairs such time as he, in his discretion, deems necessary and diligent.

This investment circular is intended to provide prospective investors with all the facts concerning the proposed investment which might affect his decision to invest. Estimates of income and operating costs, debt service and cash returns are based on existing facts and the best estimates of the Manager and his advisors. However, they are not intended as guarantees or warranties to the investor.

Many of the factors which may affect the LLC and its affairs are subject to change, or are not within the control of the LLC, its Manager, or its members. The extent to which such factors could restrict LLC activities or affect the value of the LLC properties is not currently ascertainable.

Factors which might affect the LLC include environmental controls, rent controls and government restrictions, adverse use of adjacent or neighboring real estate by its owners, changes in the demand for or supply of competing properties, changes in state or local tax rates and assessments, rapid depreciation in the value of the property, unexpected expenditures for repairs and maintenance, dramatic changes in general or local economic conditions, shortages or reductions in available resources or energy, acts of God or other calamities. The LLC will not be able to obtain insurance against most of these ownership risk factors.

B. Mortgage Risks

Should the LLC's revenues prove insufficient to service its loan(s) and pay property taxes and operating costs, the LLC will be required to use reserve funds. Should reserve funds be insufficient, the LLC will seek additional funds in the form of loans. If loans are unavailable or imprudent, the members will be called upon to vote and approve additional capital contributions to raise the needed funds. If additional contributions are not approved, the investor's initial capital will be placed at risk of loss should the LLC default on its obligations.

C. Tax Consequences

Limited liability companies qualify for treatment as partnerships for income tax purposes. On the sale of the property by the LLC, any sums distributed in excess of the investor's adjusted basis are presently taxed as capital gains, not ordinary income. However, no assurance can be made that capital gains tax rates will be available, or even apply.

D. Conflicts of Interest

The Manager has numerous other business responsibilities and ownership interests which will demand some or most of his time during the LLC's ownership of the property. The Manager's other interests include ownership of projects comparable to the property purchased in this transaction. To the extent his time is required on other business and ownership management decisions, he will not be involved in monitoring or marketing of the LLC's property.

SECTION 7. DESCRIPTION OF THE REAL ESTATE

A. Area Map

A map of the area immediately surrounding the property is set forth in Exhibit "J".

B. Property Profile

1. Improvements: ____
2. Zoning: ______________________________ zoning under ordinance from the City of ____________________, allowing ______________________.
3. Dimensions: ____
4. Size: ______________ square feet of net ground, exclusive of streets and rights of ways.
5. Soil: ____
6. Utilities: ____
7. Topography: ____
8. Street: ____
9. Improvements: ____

   ____

C. Legal Description

The legal description of the parcel of property being purchased is set forth in the Grant Deed in Exhibit "C".

D. Title Condition

The property's title has been searched and a copy of Schedule "B" from the preliminary title report, prepared for issuance of title and affecting use of the property, is set forth in Exhibit "E".

E. Property Condition

A checklist itemizing the many features of the property and their condition is set forth in Exhibit "F".

F. Fair Market Value

The real estate to be acquired by the LLC has been appraised at a fair market value of $________________, as of ______________, 20______. A copy of the relevant portions of the detailed fee appraisal and valuation report prepared by ________________________ is attached to this circular as Exhibit "L". The appraiser's fee for research and preparation of the report and opinion was $________________. The entire appraisal is available from the Manager on the request of any prospective investor.

SECTION 8. PROJECTED FIRST-YEAR OPERATING BUDGET

A 12-month annual budget has been prepared and is attached as Exhibit "H". The budget is referred to as an Annual Property Operating Data Sheet (APOD).

The budget estimates the probable gross rental income likely to be received and operating expenses expected to be incurred in the operations and management of the property. By an analysis of the APOD as a budget, it demonstrates the cash flow for the next 12-months of ownership by the LLC, not for a calender or tax year, which will vary.

The gross operating income on the budget represents the rents and other income anticipated to be collected and deposited to cover disbursements of operating expenses and loan payments. The gross operating income is estimated by first establishing the scheduled rental income for all units and space available to be rented, whether or not they are now rented.

A vacancy factor will always exist due to turnover of tenants, if for no other reason, such as lack of demand, oversupply of units or other fluctuations in the local or national economy. The vacancy factor is set forth on the budget and deducted from the gross scheduled income to set the gross operating income.

Actual rents will differ slightly from the budget analysis since the demand for rental and security of vacant units varies from month to month.

Presently, tenants under written rental and lease agreements occupy approximately ______% of the scheduled rental space. An itemized rent roll of tenants, the unit of space they occupy, and the rent they pay is set out on the dated rental income statement in Exhibit "I".

Spendable income calculated on the budget is for a 12-month period. The spendable income consists of rental income remaining for reserves and distribution to co-owners after payment of all operating expenses and loan payments.

The spendable income provides a cushion against unexpected increases in operating costs and any decrease in rental income. As projected on the budget, the vacancy factor would have to rise to ______% before the cushion of spendable income would be eliminated.

Taxwise, the budget projects the reportable income or loss from ownership operations anticipated to be experienced during the first year of operation. All operating expenses are deducted from the gross rental income, resulting in the net operating income (NOI). The government's depreciation schedule allows a non-cash deduction from the NOI as well as a deduction from NOI for interest accrued and paid on purchase/improvement loans.

Each co-owner will report their pro rata ownership share of the actual end-of-year reportable income or loss on their Federal Income Tax Form 1040, Schedule "E". The LLC, under the small partnership exemption, will not report on a Federal Income Tax Form 1065 and will not prepare a Schedule K-1.

SECTION 9. PROJECTED FINANCIAL BENEFITS TO MEMBERS

This income property investment program, under the budget presented and explained in Section 8, will deliver the members the following economic benefits:

1. Spendable income;
2. Equity build-up by monthly amortized loan reduction;
3. An inflationary hedge and appreciation in value; and
4. Tax benefits of annual depreciation deductions.

Typically, based on the budget, a ______% member would receive the following dollar amounts of benefit and percentage yield under the previous four categories:

Item:	Annual Amount	____% Member's Amount	____% Member's Percentage Yield
1. Spendable Income	$________________	$________________	______%
2. Loan Reduction	$________________	$________________	______%
3. Value Increase			
(____% annual rise)	$________________	$________________	______%
4. Tax Savings	$________________	$________________	______%
TOTAL Annual Benefits	**$________________**	**$________________**	**______%**

These projections are, at best, estimates of the dollar and percentage amounts expected from the property's first 12 months of operations and will differ from the end-of-year report since it will be for only a portion of the calender year. Also, the dollar amount of each of the benefits received will vary.

Spendable income will be disbursed quarterly beginning ____ months after closing. Earnings represented by the annual loan reduction and increased property value will be cashed out and distributed when a refinance or resale of the property occurs. Tax benefits from reportable losses result in a reduced income tax payment for the member who qualifies when filing his return.

SECTION 10. BENEFITS RECEIVED BY MEMBERS

The LLC shall be comprised of ownership interests held by Class A Members and Class B Members. Cash investors shall hold Class A interests; ____ shall hold Class B interests.

Class A Members shall have priority over Class B Members' interests on all cash disbursements made to members by the LLC.

Class A Members shall receive the following benefits:

1. ______% annual cash disbursements from the net spendable income projected to be earned. Net spendable income consists of those funds remaining from gross rental income after payment of all operating expenses, management fees, and debt service. Disbursements of unreserved spendable income will commence beginning with spending income generated for the ____________________ quarter of operations. Any net spendable income received during the interim period will be placed in the reserve account and used for its purposes.

   Spendable income will be first distributed to the Class A Members until they have received the amount of their cumulative annual percentage, then next to the Class B Members until they have received the amount of their cumulative annual percentage. Any funds then remaining will be distributed between all members in proportion to their percentage of ownership.

2. Equity build-up results from loan reduction due to the amortization of the mortgage financing encumbering the property. This equity build-up is converted to cash and distributed on refinance or resale of the property.

3. Sale and refinance proceeds remaining after payment of all costs and mortgages on the sale/refinance and repayment of loans made by members will be first distributed to Class A Members until they have received their contributions, plus ___________% annually thereon from the date of contribution, less any disbursements received.

   Next, proceeds then remaining will be distributed to the Class B Members until they have received their contributions plus _____________% annually thereon from the date of contribution, less any disbursements received.

   Then, any proceeds remaining will be distributed to all members to be shared in accordance with their percentage of ownership.

4. Depreciation deductions will be taken by each individual member on his capital contribution and pro rata share of purchase-assist or improvement loans. The depreciation schedule shall be chosen by the member and his accountant under the appropriate government-issued depreciation schedule.

SECTION 11. COMPENSATION AND DUTIES OF THE MANAGER

The Manager will receive no compensation from any aspect of this transaction, other than those set forth in this section.

A. Contribution to the LLC

A contract to purchase the real estate has been entered into by ______________________________, an individual, as the Buyer. The purchase rights created by entering into this contract will be assigned to the LLC for its acquisition of the property prior to closing. In exchange for the assignment, the above named individual is receiving Class B membership interests valued at $_______________.

The Manager will receive a fee of $________________ cash for services in the creation and formation of the LLC entity, solicitation of members and accompanying time and effort.

B. Management of the Property

The LLC and the members shall employ ____
to manage the LLC property. The property Manager shall receive a fee of ____________________
____

[See Property Management Agreement, Exhibit “K”]

All members will sign the property management agreement to provide for themselves a form for qualifying for the federal income tax rental loss deduction.

Should a later resale of the property occur, the Manager is to receive ______% of the price of any resale, and in the event of a refinance, ______% of the refinancing, if he is the procuring cause of the resale or refinance.

SECTION 12. THE MANAGER

The Manager of this LLC shall be ____.

The Manager shall be responsible for supervising the LLC’s operations, including compliance with legal and regulatory requirements, and the preparation and forwarding of periodic reports to the members. [See Section 15, Reports to Investors]

The Manager has the ultimate authority in all matters affecting the ongoing business affairs of the LLC and establishes guidelines with respect to the LLC’s investment.

SECTION 13. RESERVE FUND ACCOUNT

A reserve fund will be established from contributions remaining after expenditures made in the acquisition of the real estate payment and payment of organizational fees. These expenditures are estimated to total $_______________. [See Section 5, Use of the Contribution Proceeds]

Also, during the first ______ quarters of operations, all net spendable income will be deposited into this account. The account will be maintained at a bank in an interest bearing account in the name of the LLC.

The purpose of this reserve fund is to cover any unforeseen and unforseeable emergency costs. Business reversals due to local and national economic conditions occasionally occur and cannot be determined in advance. The reserve fund will cover any deficit cash flow which might occur, with the expectation of avoiding the need for additional capital contriubtions from the investors. The fund is to be handled at the sole discretion of the manager, for the general benefit of the LLC.

SECTION 14. THE LIMITED LIABILITY COMPANY ASPECTS

The operating agreement, which each subscribing Class A investor agrees to by signing duplicate copies of its signature page, is attached to this investment circular as Addendum “B”. Set forth in the operating agreement are all the terms for sharing the income and losses from the operation of the property, the obligations of the manager, the rights of the members and the buy-out provisions should an event occur which terminates a member’s interest. Some of the more important aspects are reviewed in this section.

For tax purposes, the ownership is intended to be treated as a partnership. There should be no taxation of the LLC, except for the California annual franchise tax. The LLC will not report on a Federal Income Tax Form 1065, since 10 or fewer members will participate in the program. Each member will include in his individual tax return on Schedule "E" his pro rata share of income and expenses from operations, including interest. Members will choose their own depreciation schedules.

The operations of the real estate will be supervised by the Manager. Should he die or be terminated as the Manager by a majority vote in ownership, then another Manager will be appointed by the members.

Buy-out provisions cover the termination of members' interests due to events ranging from death, bankruptcy or withdrawal, to expulsion by court order or by all the remaining members. Should one member be terminated, the other members have the option to purchase his interest.

The operating agreement calls for the LLC to terminate on any of these events. However, the remaining members may vote to continue after an event occurs which causes the LLC to terminate.

Two processes are provided for determining the price to be paid to a terminated member should the member be bought out by the remaining members. The real estate's full current value is received only by those persons whose interest is held by their estate. Those members terminated for "voluntary" events such as judgment debtor attachments, bankruptcy, withdrawal, etc., will receive only a return of their invested capital. No interest or additional value will be received.

The interests held by the members are not readily marketable. No market exists for the resale of membership interests in LLCs, and one will not likely develop. Liquidity is further restricted as the Manager has the right of first refusal to purchase any member's interest which is offered for sale. If he chooses not to do so, the remaining members have the right to purchase the interest sold. Should all members not exercise their right to purchase, any sale to a non-member which the remaining members do not approve is also cause for termination of the interest sold. The value of the buy out option on such a sale to a third party is the return only of the capital invested.

The liability of all members, including the Manager, will be limited to the amount of their capital contributions. The Manager will file articles of organization for the LLC with the Secretary of State to establish this limitation on liability.

SECTION 15. REPORTS TO INVESTORS

Periodic reports to investors will include:

1. On closing of the property acquisition:
   - a copy of the recorded LLC-1 (articles of organization) of the limited liability company;
   - a copy of the operating agreement signed by all members and setting forth each member's percentage of ownership;
   - a copy of the recorded grant deed to the LLC;
   - a copy of the policy of title insurance on the LLC's ownership of the property; and
   - a copy of the beginning LLC balance sheet on acquisition of the property.
2. After the end of each calendar quarter:
   - an itemized income statement on year-to-date rental income, operating expenses and interest and principal payments on the loan(s).
3. After the end of each calendar year:
   - a balance sheet showing the LLC's end-of-year net worth and financial position; and
   - an itemized income and loss statement on end-of-year rental income, operating expenses and interest and principal payments on loan(s).

NOTICE: The LLC will not report on a Federal Income Tax Form 1065, and a K-1 Schedule for the members will not be prepared or filed:

Reports available for inspection or copying at the office of the LLC include:

- rental or lease agreements with tenants;
- monthly operating statements;
- bank account records; and
- the LLC file.

NOTICE: Your accountant will need some of the annual reports and the initial costs of acquisition to prepare your annual 1040 federal income tax return and a Schedule "E", for rental income, expenses, interest and depreciation.

Exhibit "A"

PURCHASE AGREEMENT

Income Property other than One-to-Four Residential Units

DATE: ____________, 20______, at ____, California.

Items left blank or unchecked are not applicable.

FACTS:

1. Received from ____, as the Buyer(s),
- 1.1 the sum of $_______________, evidenced by ☐ personal check, or ☐ ____________________________, payable to ____, for deposit only on acceptance of this offer.
- 1.2 Deposit to be applied toward Buyer's obligations under this agreement to purchase property
- 1.3 situated in the City of _________________________, County of ____________________, California,
- 1.4 referred to as ____,
- 1.5 including personal property, ☐ see attached Personal Property Inventory. [See **ft** Form 256]

2. This agreement is comprised of this four-page form and ______ pages of addenda/attachments.

TERMS: Buyer to pay the purchase price as follows:

3. Cash payment through escrow, including deposits, in the amount of . . . . $_______________
- 3.1 Other consideration paid through escrow __________________________________ . . . . $_______________

4. Buyer to obtain a ☐ first, or ☐ second, trust deed loan in the amount of . . . . $_______________
payable approximately $_______________ monthly for a period of ______ years.
Interest on closing not to exceed ______%, ☐ ARM, type _________________________.
Loan points not to exceed _____________.
- 4.1 ☐ Unless Buyer, within ______ days after acceptance, hands Seller satisfactory written confirmation Buyer has been pre-approved for the financing of the purchase price, Seller may terminate the agreement. [See **ft** Form 183]

5. ☐ Take title subject to, or ☐ Assume, an existing first trust deed note held by ____ with an unpaid principal balance of . . . . $_______________
payable $_______________ monthly, including interest not exceeding _____%, ☐ ARM, type __________________________, plus a monthly tax/insurance impound payment of $______________. ____
- 5.1 At closing, loan balance differences per beneficiary statement(s) to be adjusted into: ☐ cash, ☐ carryback note, or ☐ sales price.
- 5.2 The impound account to be transferred: ☐ charged, or ☐ without charge, to Buyer.

6. ☐ Take title subject to, or ☐ Assume, an existing second trust deed note held by ____ with an unpaid principal balance of . . . $_______________
payable $_______________ monthly, including interest not exceeding ______%, ☐ ARM, type ______________________________, due _____________, 20 ______.

7. Assume a tax bond or assessment lien with an unpaid principal balance of . . . . $_______________

8. Note for the balance of the purchase price in the amount of. . . . . $_______________
to be executed by Buyer in favor of Seller and secured by a trust deed on the property junior to any above referenced financing, payable $_______________ monthly, or more, beginning one month after closing, including interest at ______% per annum from closing, due _______________ years after closing.
- 8.1 This note and trust deed to contain provisions to be provided by Seller for: ☐ due-on-sale, ☐ prepayment penalty, ☐ late charges, ☐ ______________.
- 8.2 ☐ A Carryback Disclosure Statement is attached as an addendum. [See **ft** Form 300]
- 8.3 ☐ Buyer to provide a Request for Notice of Default and Notice of Delinquency to senior encumbrancers. [See **ft** Form 412]
- 8.4 Buyer to hand Seller a completed credit application on acceptance. [See **ft** Form 302]
- 8.5 Within ______ days of receipt of Buyer's credit application, Seller may terminate the agreement based on a reasonable disapproval of Buyer's creditworthiness.
- 8.6 Seller may terminate the agreement on failure of the agreed terms for priority financing. [See **ft** Form 183]
- 8.7 As additional security, Buyer to execute a security agreement and file a UCC-1 financing statement on any property transferred by Bill of Sale. [See **ft** Form 436]

9. **Total Purchase Price is** . . . . $ 0.00

10. ACCEPTANCE AND PERFORMANCE:

10.1 This offer to be deemed revoked unless accepted in writing ☐ on presentation, or ☐ within ______ days after date, and acceptance is personally delivered or faxed to Offeror or Offeror's Broker within this period.

10.2 After acceptance, Broker(s) are authorized to extend any performance date up to one month.

10.3 On failure of Buyer to obtain or assume financing as agreed by the date scheduled for closing, Buyer may terminate the agreement.

10.4 Buyer's close of escrow is conditioned on Buyer's prior or concurrent closing on a sale of other property, commonly referred to as ______________________________.

10.5 Any termination of the agreement shall be by written Notice of Cancellation timely delivered to the other party, the other party's Broker or escrow, with instructions to escrow to return all instruments and funds to the parties depositing them. [See **ft** Form 183]

10.6 Both parties reserve their rights to assign and agree to cooperate in effecting an Internal Revenue Code §1031 exchange prior to close of escrow on either party's written notice. [See **ft** Forms 171 or 172]

10.7 Before any party to this agreement files an action on a dispute arising out of this agreement which remains unresolved after 30 days of informal negotiations, the parties agree to enter into non-binding mediation administered by a neutral dispute resolution organization and undertake a good faith effort during mediation to settle the dispute.

10.8 Should Buyer breach the agreement, Buyer's monetary liability to Seller is limited to ☐ $____________, or ☐ the deposit receipted in Section 1.

11. DUE DILIGENCE CONTINGENCIES:

Within ______ days after receipt or occurrence of any of the following conditions, Buyer may terminate the agreement based on Buyer's reasonable disapproval of the condition.

11.1 Income and expense records, leases, property management and other service contracts, permits or licenses affecting the operation of the property which Seller will make available to Buyer on acceptance.

11.2 Rental Income Rent Roll Statement itemizing, by unit, the tenant's name, rent amount, rent due date and delinquencies, deposits, rental period and expiration, and any rental incentives, bonuses or discounts signed by Seller and handed to Buyer on acceptance. [See **ft** Form 380]

11.3 Seller's Natural Hazard Disclosure Statement to be signed by Seller and handed to Buyer on acceptance. [See **ft** Form 314]

11.4 Condition of Commercial Property Disclosure — Commercial TDS to be signed by Seller and Seller's Broker and handed to Buyer on acceptance. [See **ft** Form 304-1] Solar Shade Control Notices sent or received by Seller to be handed to Buyer on acceptance.

11.5 Inspection of the property by Buyer, his agent or consultants within ______ days after acceptance for value and condition sufficient to justify the purchase price.

11.6 Preliminary title report for the policy of title insurance, which Seller will cause escrow to hand Buyer as soon as reasonably possible after acceptance.

11.7 An estoppel certificate executed by each tenant affirming the terms of their occupancy, which Seller will hand Buyer prior to seven days before closing. [See **ft** Form 598]

11.8 Criminal Activity and Security Disclosure Statement prepared by Seller setting forth recent criminal activity on or about the property relevant to the security of persons and their belongings on the property, and any security arrangements undertaken or which should be undertaken in response. [See **ft** Form 321]

11.9 ☐ See attached Due Diligence Contingencies Addendum for additional conditions. [See **ft** Form 279]

12. PROPERTY CONDITIONS:

12.1 Seller to furnish prior to closing:

a. ☐ a structural pest control inspection report and certification of clearance of corrective conditions.

b. ☐ a home inspection report prepared by an insured home inspector showing the land and improvements to be free of material defects.

c. ☐ a one-year home warranty policy:
Insurer ______________________________
Coverage ______________________________

d. ☐ a certificate of occupancy, or other clearance or retrofitting, required by local ordinance for the transfer of possession or title.

e. ☐ ______________________________

f. ☐ ______________________________

12.2 Smoke detector(s) and water heater bracing exist in compliance with the law, and if not, Seller to install.

12.3 Seller to maintain the property in good condition until possession is delivered.

12.4 Fixtures and fittings attached to the property include, but are not limited to: window shades, blinds, light fixtures, plumbing fixtures, curtain rods, wall-to-wall carpeting, draperies, hardware, antennas, air coolers and conditioners, trees, shrubs, mailboxes and other similar items.

12.5 New agreements and modifications of existing agreements to rent units, or to service, alter or equip the property, will not be entered into by Seller without Buyer's prior written consent, which will not be unreasonably withheld.

13. CLOSING CONDITIONS:

13.1 This transaction to be escrowed with ______________________________.
Parties to deliver instructions to escrow as soon as reasonably possible after acceptance.

a. ☐ Escrow holder is authorized and instructed to act on the provisions of this agreement as the mutual escrow instructions of the parties and to draft any additional instructions necessary to close this transaction. [See **ft** Form 401]

b. ☐ Escrow instructions, prepared and signed by the parties, are attached to be handed to escrow on acceptance. [See **ft** Form 401]

13.2 Escrow to be handed all instruments needed to close escrow on or before ______________, 20______, or within ______ days after acceptance. Parties to hand escrow all documents required by the title insurer, lenders or other third parties to this transaction prior to seven days before the date scheduled for closing.

a. Each party to pay its customary escrow charges. [See **ft** Forms 310 and 311]

13.3 Title to be vested in Buyer or Assignee free of encumbrances other than those set forth herein. Buyer's interest in title shall be insured by ______________________________ title company on a(n) ☐ CLTA standard, ☐ ATLA owner's, or ☐ ALTA binder, policy of title insurance.

a. Endorsements ______________________________

b. ☐ Seller, or ☐ Buyer, to pay the title insurance premium.

13.4 Buyer to furnish a new fire insurance policy covering the property.

13.5 Taxes, assessments, insurance premiums, rents, interest and other expenses to be pro rated to close of escrow, unless otherwise provided.

a. ☐ Attached is a notice of your Supplemental Property Tax Bill. [See **ft** Form 317]

13.6 Bill of Sale to be executed for any personal property being acquired.

a. ☐ A UCC-3 Condition of Title Report to be ordered from the Secretary of State and approved by Buyer prior to close of escrow.

13.7 Seller to assign, and title to be subject to, all existing leases and rental agreements. [See **ft** Form 595]

a. Seller to notify each tenant of the change of ownership on or before the close of escrow. [See **ft** Form 554]

13.8 Security deposits held by Seller to be handed to Buyer on close of escrow. Seller to notify each tenant of the transfer of the security deposit on close of escrow, with a copy of each notice to Buyer through escrow. [See **ft** Form 586]

13.9 Delinquent unpaid rent to be treated as paid. Any recovery by Buyer of Seller's portion of delinquent rent and pro rated delinquent rent credited to Buyer shall be refunded to Seller on collection by Buyer.

13.10 Service and equipment contracts to be assumed by Buyer include ______________________________
____

a. Contracts assumed by Buyer to be pro rated to close of escrow.

13.11 Possession of the property and keys/access codes to be delivered on close of escrow.

13.12 If Seller is unable to convey marketable title as agreed, or if the improvements on the property are materially damaged prior to closing, Buyer may terminate the agreement. Seller to pay all reasonable escrow cancellation charges. [See **ft** Form 183]

14. NOTICE OF YOUR SUPPLEMENTAL PROPERTY TAX BILL:

California property tax law requires the Assessor to revalue real property at the time the ownership of the property changes. Because of this law, you may receive one or two supplemental tax bills, depending on when your loan closes.

The supplemental tax bills are not mailed to your lender. If you have arranged for your property tax payments to be paid through an impound account, the supplemental tax bills will not be paid by your lender. It is your responsibility to pay these supplemental bills directly to the Tax Collector.

If you have any questions concerning this matter, please call your local Tax Collector's Office.

15. BROKERAGE FEE:

15.1 Parties to pay the below mentioned Broker(s) a fee now due of ________________________ as follows:
 a. Seller to pay the brokerage fee on the change of ownership.
 b. The party wrongfully preventing this change of ownership to pay the brokerage fee.

15.2 Buyer's Broker and Seller's Broker, respectively, to share the brokerage fee _________:__________.

15.3 ☐ Attached is the Agency Law Disclosure. [See **ft** Form 305]

15.4 Broker is authorized to report the sale, its price and terms for dissemination and use of participants in brokerage trade associations or listing services.

16. ____
____
____
____

Buyer's/ Selling Broker: ____________________	Seller's/ Listing Broker: ____________________
Broker's DRE Identification #: ____________	Broker's DRE Identification #: ____________
Selling Agent: ____________________	Listing Agent: ____________________
Agent's DRE Identification #: ____________	Agent's DRE Identification #: ____________
Signature: ____________________	Signature: ____________________
Is the agent of: ☐ Buyer exclusively. ☐ Both Seller and Buyer.	Is the agent of: ☐ Seller exclusively. ☐ Both Seller and Buyer.
Address: ____________________ ____________________	Address: ____________________ ____________________
Phone: ____________________	Phone: ____________________
Fax: ____________________	Fax: ____________________
Email: ____________________	Email: ____________________

I agree to the terms stated above.	**I agree to the terms stated above.**
☐ See Signature Page Addendum. [**ft** Form 251]	☐ See Signature Page Addendum. [**ft** Form 251]
Date: ____________, 20_____	Date: ____________, 20_____
Buyer: ____________________	Seller: ____________________
Signature: ____________________	Signature: ____________________
Buyer: ____________________	Seller: ____________________
Signature: ____________________	Signature: ____________________

REJECTION OF OFFER

Undersigned hereby rejects this offer in its entirety. No counteroffer will be forthcoming.

Date: ____________, 20_____

Name: ______________________________

Signature: ______________________________

Name: ______________________________

Signature: ______________________________

Exhibit "B"

ESCROW INSTRUCTIONS

Buyer and Seller Instructions

DATE: ____________, 20______.

Items left blank or unchecked are not applicable.

Escrow number ________________

Escrow/Brokerage company ____

Licensed by the Department of ________________________, State of California, license # __________________

Escrow officer ____

Address ____

An escrow administrative fee will be charged each principal for postponement of closing by two months or more beyond the originally scheduled closing date in these instructions or on cancellation of these instructions, due to acts or omissions of either principal.

Postponement Fee . . . $____________
Cancellation Fee . . . . $____________

Buyer's Initials	Seller's Initials
______ ______	______ ______

Phone number ____

Fax ____

Buyer ____

Seller ____

TERMS OF SALE: (for escrow use only)

$_______________ TOTAL Consideration Seller to receive from Buyer
$_______________ Assessment Bond paid with property taxes
$_______________ 1st Trust Deed of Record
$_______________ 2nd Trust Deed of Record
$_______________ Trust Deed to record
$_______________ Trust Deed to record
$_______________ Cash through Escrow
$_______________ Other Consideration ____

1. You, the escrow officer, are authorized and instructed as follows:

1.1 Buyer deposits herewith the sum of $_______________.

1.2 On or before _____________, 20______, the date set for closing, Buyer will deposit with You on your request the additional sum of $_______________, to make a total deposit of $_______________.

1.3 Buyer will deliver to You prior to the date set for closing any additional funds and instruments required which You request.

1.4 You may thereafter use these funds and instruments until such time as You have received written instruction not to do so. Brokers are authorized to extend any performance date up to one month.

1.5 Close of escrow is the date instruments are recorded.

2. Upon the use of these funds and instruments, You are to obtain the following policy of title insurance, with the usual title company exceptions, in the following checked type and form:
Title to be vested in Buyer or Assignee free of encumbrances other than those set forth herein. Buyer's interest in title to be insured under a policy issued by ____
as a(n) ☐ Homeowner(s) policy (one-to-four units), ☐ Residential ALTA-R policy (vacant or improved residential parcel), ☐ Owner's policy (other than one-to-four units), ☐ Joint Protection policy (also naming the Carryback Seller or Purchase-assist Lender), or ☐ Binder (to insure resale or refinance within two years).
Endorsements ____
____

2.1 With title insurance in the amount of $_______________ covering the following described real property, commonly known as ____
and legally described as ____
____
____
____,

2.2 Showing title vested in ____

2.3 Subject to the following only:

a. All General and Special taxes for the ________________________ fiscal year, including any special district taxes or personal property taxes collected with the ad valorem taxes.

b. Assessments and Bonds with an unpaid balance of $_______________.

c. Any covenants, conditions, restrictions, reservations, rights, right of ways and easements of record, or in deed to record, and EXCEPTIONS of water, minerals, oil, gas, and kindred substances, on or under said real property, now of record, or in deed to record.

d. First encumbrance now of record with an unpaid balance of $_______________, payable $_______________ monthly, including interest of ______% per annum. ☐ ARM

e. Second encumbrance now of record with an unpaid balance of $_______________, payable $_______________ monthly, including interest of ______% per annum, all due and payable _____________, 20______.

f. Deed of Trust to record in the amount of $_______________.
Execution of loan documents under §2.3f or §2.3g shall be Buyer's approval of their terms. Should Seller carry back under §2.3h, You are to obtain Seller's written approval of the loan terms for any Deed of Trust to record.

g. Deed of Trust to record in the amount of $_______________.

h. Purchase money Deed of Trust with Assignment of Rents on standard form, executed by Buyer securing a note for $_______________ in favor of Seller as their interests appear on the preliminary title report, with interest at ______ % per annum from close of escrow, principal and interest payable in installments of $_______________, or more, each on the same day of every calendar month, beginning one month from ☐ close of escrow, or ☐ _____________, 20______, and continuing until ____.
You, as escrow holder, are instructed to prepare the note and Deed of Trust and insert the correct principal amount and correct first payment date, interest accrual date and due date as soon as they can be determined. The address for deliver of note payments is ____________________________________
____.

3. You are to obtain at Seller's expense beneficiary statements on the Deed(s) of Trust (or mortgage) now of record (§2.3d and §2.3e above). If the principal balances shown by the statements are more or less than the amount shown above, You are to make adjustments as checked below:

☐ cash through escrow, ☐ total consideration, or ☐ purchase-money Deed of Trust.

3.1 You are to deliver to Buyer for Buyer's approval prior to close of escrow a copy of the beneficiary statement for each Deed of Trust to remain of record on closing.

3.2 You are to deliver to Seller prior to close of escrow, any payoff demand necessary to eliminate encumbrances so You can comply with conditions in §2.3 for title insurance.

4. You are to obtain at Seller's expense a UCC-3 clearance on the following described personal property
____
____
____
and cause title thereto to be vested in Buyer subject to the following UCC-1 financing statements:

a. A UCC-1 obligation in the approximate amount of $_______________, payable $_______________ per month, including an annual percentage rate of ______%, all due and payable _____________, 20______.

b A UCC-1 form in favor of Seller at Buyer's expense as additional security for any note carried back under §2.3h above.

5. Prior to close of escrow, Buyer is to hand You a sufficient hazard insurance policy. In the event Seller carries back under §2.3h above, then Seller is to be named as additional loss payee. The policy is to be in an amount sufficient to cover all lien balances or the coverage demanded by the new lender if greater in amount.

6. ☐ Prior to the close of escrow and at Seller's expense, Seller to hand You a structural pest control clearance on the subject property.

7. ☐ Prior to close of escrow and at Seller's expense, You are to obtain a one-year policy of homeowner's warranty issued by ____, in favor of Buyer, covering ____.

8. Prior to the close of escrow and at Seller's expense, You are to obtain from the homeowners' association (HOA) of any common interest development which includes the described property the following checked item(s) for Buyer's approval:

8.1 ☐ A statement of condition of assessments;

8.2 ☐ Copies of the association's articles, bylaws, CC&Rs, collection and lien enforcement policies, operating budget, operating rules, CPA's financial review, insurance policy summary and any age restriction statement;

8.3 ☐ Copies from the association of any notice to Seller of CC&R violations, any list of construction defects, and any assessment charges not yet payable.

9. ☐ You are authorized and instructed to prepare assignments for all existing lease/rental agreements.

10. The following checked prorations and adjustments shall be computed by You on a monthly basis of 30 days as of ☐ close of escrow, or ☐ _____________, 20______, on which date Buyer is to be treated as the owner for the entire day:

a. ☐ Taxes, based on latest tax statement available and Seller warrants that no reassessment or reassessment activity has since occurred

b. ☐ Hazard (fire) insurance premium

c. ☐ Interest on existing note(s) and Deed(s) of Trust

d. ☐ Rents and deposits based on rental statement handed to You and approved by Buyer and Seller prior to close of escrow

e. ☐ Impounds, under §2.3d or §2.3e above, together with an assignment of these impounds to Buyer through escrow

f. ☐ Association assessments for any common interest development which includes the property

g. ☐ ____

10.1 You are to account for the above prorations and adjustments into the item checked below:
☐ cash through escrow, ☐ total consideration, or ☐ purchase-money Deed of Trust.

11. You are to promptly obtain and hand Buyer a preliminary title report on the property from title company for Buyer's approval or disapproval and cancellation of this transaction within ______ days of receipt by Buyer or Buyer's Broker of the report.

12. The Grant Deed to state the tax statements are to be mailed to ____

____

at ____.

13. Escrow is herewith handed a purchase agreement dated _____________, 20______ and (a) counteroffer dated _____________, 20______, entered into by Buyer and Seller regarding the sale of the property which authorizes and instructs escrow to act on the provisions of the agreement as mutual escrow instructions to close this transaction.

13.1 Any inconsistencies between the provisions in the purchase agreement and provisions in the instructions prepared by escrow shall be controlled by the instructions prepared by escrow.

14. The close of escrow and disbursement of funds can be affected based on the form of the deposit with escrow. Funds deposited in cash or by electronic payment allow for closing and disbursement on or after the business day of deposit with the escrow's financial institution. Funds deposited by cashier's check allow for closing and disbursement on or after two business days after deposit with the escrow's financial institution. All other forms of deposit cannot be disbursed and thus, the closing cannot occur until the funds are made available to escrow by the escrow's financial institution.

15. Buyer is required to withhold 10% of each Seller's share of the sales price for payment of Seller's federal income taxes on this transaction, unless Seller meets one of the following conditions:

15.1 Each Seller provides Buyer with their taxpayer identification number and declares under penalty of perjury to be a citizen of the United States or a resident alien [**ft** Form 301];

15.2 Buyer declares under penalty of perjury the property will be used as their residence and the sales price is $300,000 or less [**ft** Form 301]; or

15.3 Seller requests and obtains a withholding certificate from the Internal Revenue Service (IRS) authorizing a reduced amount or no amount be withheld.

16. Buyer is required to withhold 3⅓% of each Seller's share of the sales price for payment of Seller's California income taxes on this transaction, unless one of the following exemptions exists:

16.1 Seller executes a real estate withholding certificate, FTB form 593-C, declaring the sale is exempt due to:

a. The property sold is or was last used as Seller's principal residence;

b. The property sold was the decedent's principal residence;

c. The property was sold as part of an IRC §1031 exchange;

d. The property was taken by involuntary conversion and will be replaced under IRC §1033; or

e. The property was sold at a taxable loss.

16.2 Buyer is also exempt from withholding 3⅓% of Seller's share of the sales price if:

a. The property was sold for less than $100,000;

b. Buyer is acquiring the property by a deed-in-lieu of foreclosure; or

c. Seller is a bank acting as a trustee under an agreement other than a Deed of Trust.

16.3 On an installment sale, Buyer may agree to withhold on each payment on the carryback note and thus defer withholding. [FTB Forms 593-I and 597]

17. In the event You become involved in litigation between Buyer and Seller arising out of this transaction, Buyer and Seller shall pay a reasonable fee for attorney services which You may be required to incur.

17.1 Before any party to this agreement files an action on a dispute arising out of this agreement which remains unresolved after 30 days of informal negotiations, the parties agree to enter into non-binding mediation administered by a neutral dispute resolution organization and undertake a good faith effort during mediation to settle the dispute.

18. You are authorized to use Seller's instruments when You hold and can deliver to Seller the money and instruments to be delivered to Seller under these instructions.

18.1 You are authorized to pay and charge Seller for the following checked item(s):

a. ☐ Bonds, assessments, taxes and other liens of record to show title as called for.

b. ☐ Documentary transfer taxes as required.

c. ☐ Brokerage fees: $______________ to ____
$______________ to ____
$______________ to ____

d. ☐ Transaction coordinator's fees:
$______________ to ____
$______________ to ____

e. ☐ Title insurance premium on the policy to be issued to Buyer.

f. ☐ Costs of recording Seller's Grant Deed.

g. ☐ Escrow fees for your services and any charges incurred by escrow on Seller's behalf.

h. ☐ Payables submitted to escrow for payment by Seller or Seller's Broker.

i. ☐ Attorney fees: $______________ to ____

j. ☐ ____

19. You are authorized to pay and charge Buyer for the following checked item(s):

a. ☐ Escrow fees for your services and any charges incurred by escrow on Buyer's behalf.

b. ☐ Costs of and lender's charges for recording or assuming any Deed of Trust, including a policy of title insurance for any new lender.

c. ☐ Attorney fees: $______________ to ____

d. ☐ Brokerage fees: $______________ to ____

e. ☐ Title insurance premium on the policy to be issued to Buyer.

f. ☐ ____

20. ____
____
____

I hereby agree to perform all acts called for above to be performed by Seller.	**I hereby agree to perform all acts called for above to be performed by Buyer.**
Date: ____________, 20______	Date: ____________, 20______
Seller: ______________________________	Buyer: ______________________________
Signature: ______________________________	Signature: ______________________________
Seller: ______________________________	Buyer: ______________________________
Signature: ______________________________	Signature: ______________________________
Address: ______________________________	Address: ______________________________
______________________________	______________________________
Phone: ______________________________	Phone: ______________________________
Fax: ______________________________	Fax: ______________________________
Email: ______________________________	Email: ______________________________

Exhibit "C"

Grant Deed

(Include a copy of the grant deed from the seller to the LLC, available from escrow.)

Exhibit "D"

GOOD FAITH ESTIMATE OF BUYER'S ACQUISITION COSTS

On Acquisition of Property

NOTE: This cost sheet is prepared to assist the buyer to estimate the total cost of acquisition for a property to anticipate the amount of funds likely needed to close, and the source of these funds.

The figures estimated in this cost sheet may vary at the time of closing due to periodic changes in lender demands, escrow fees, other charges and prorates, and thus constitute an opinion, not a guarantee of the preparer.

If acquiring IRC §1031 replacement property, also use a §1031 Profit and Basis Recap Sheet to compute the income tax consequences of the transaction. [See **ft** Form 354]

DATE: _____________, 20______, at ____, California.

1. This is an estimate of acquisition costs and the funds required to close the following transaction:
☐ Purchase Agreement ☐ Exchange agreement ☐ Counteroffer ☐ Escrow Instructions ☐ Option

1.1 entered into by ____,

1.2 dated _____________, 20______, at ____, California,

1.3 regarding real estate referred to as ____
____.

2. EXISTING FINANCING ASSUMED:

2.1 First Trust Deed of Record . . . . $______________

2.2 Second Trust Deed of Record . . . . $______________

2.3 Other Encumbrances/Liens/Bonds . . . . $______________

2.4 TOTAL Encumbrances Assumed [lines 2.1 to 2.4] . . . . (+)$ 0.00

a. If loan balance adjustments are to be made in cash, the total funds required to close escrow at §10 and §12 will vary.

3. INSTALLMENT SALE FINANCING:

3.1 Seller Carryback Financing . . . . (+)$______________

4. NEW FINANCING ORIGINATED:

4.1 New Loan Amount . . . . (+)$______________

4.2 Points/Discount . . . . $______________

4.3 Appraisal Fee . . . . $______________

4.4 Credit Report Fee . . . . $______________

4.5 Miscellaneous Origination Fees . . . . $______________

4.6 Prepaid Interest . . . . $______________

4.7 Mortgage Insurance Premium . . . . $______________

4.8 Lender's Title Policy Premium . . . . $______________

4.9 Tax Service Fee . . . . $______________

4.10 Loan Brokerage Fee . . . . $______________

4.11 Other ____ . . . . $______________

4.12 TOTAL New Financing Costs [lines 4.2 to 4.11] . . . . (+)$ 0.00

5. PURCHASE COSTS AND CHARGES:

5.1 Assumption Fees (First) . . . . $______________

5.2 Assumption Fees (Second) . . . . $______________

5.3 Escrow Fee . . . . $______________

5.4 Notary Fee . . . . $______________

5.5 Document Preparation Fee . . . . $______________

5.6 Recording Fee/Transfer Taxes . . . . $______________

5.7 Title Insurance Premium . . . . $______________

5.8	Property Condition Reports	$	
5.9	Cost of Compliance Repairs	$	
5.10	Other ______	$	
5.11	Other ______	$	
5.12	TOTAL Closing Costs [lines 5.1 to 5.11]		(+)$ 0.00
5.13	Down Payment on Price		(+)$
6.	**TOTAL ESTIMATED ACQUISITION COST** [lines 2.4, 3.1, 4.1, 4.12, 5.12 and 5.13]		(=)$ 0.00
	6.1 No post-closing repairs or renovation cost are included here.		
7.	**FUNDS REQUIRED TO CLOSE ESCROW:**		
7.1	Down Payment On Price (From line 5.13)		(+)$ 0.00
7.2	Closing Costs (From line 5.12)		(+)$ 0.00
7.3	New Loan Proceeds (From line 4.1)		(+)$ 0.00
7.4	New Financing Costs (From line 4.12)		(+)$ 0.00
7.5	Impounds for New Financing		(+)$
7.6	Hazard Insurance Premium		(+)$
8.	**PRORATES DUE BUYER AT CLOSE:**		
8.1	Unpaid Taxes/Assessments	$	
8.2	Interest Accrued and Unpaid	$	
8.3	Unearned Rental Income	$	
8.4	Tenant Security Deposits	$	
8.5	TOTAL Prorates Due Buyer [lines 8.1 to 8.4]		(-)$ 0.00
9.	**PRORATES DUE SELLER AT CLOSE:**		
9.1	Prepaid Taxes/Assessments	$	
9.2	Impound Account Balance	$	
9.3	Prepaid Homeowners' Assessment	$	
9.4	Prepaid Ground Lease Rent	$	
9.5	Unpaid Rents assigned to Buyer	$	
9.6	Other ______	$	
9.7	TOTAL Prorates Due Seller [lines 9.1 to 9.6]		(+)$ 0.00
10.	**TOTAL FUNDS REQUIRED TO CLOSE ESCROW:** [lines 7.1 to 7.6, less 8.5 plus 9.7].		(=)$ 0.00
	10.1 See §2.4.a. adjustments.		
11.	**SOURCE OF FUNDS REQUIRED TO CLOSE ESCROW:**		
11.1	New First Loan Amount (From line 4.1)	$ 0.00	
11.2	New Second Loan Amount (Net loan proceeds)	$	
11.3	Third-Party Deposits	$	
11.4	Buyer's Cash	$	
12.	**TOTAL FUNDS REQUIRED TO CLOSE ESCROW:** (Same as line 10)		(=)$ 0.00

I have prepared this estimate based on my knowledge and readily available data.	**I have read and received a copy of this estimate.**
Date: ______, 20____	Date: ______, 20____
Broker: ______	Buyer's Name: ______
Agent: ______	Signature: ______
Signature: ______	Signature: ______

Exhibit "E"

Preliminary Title Report

(Obtain and include Schedule "B" from Preliminary Title Report to set forth the taxes, CC&Rs and encumbrances of record on the property.)

Exhibit “F”

Condition of Property

(If available, include a copy of a Building Inspection Report.)

Exhibit "G"

NATURAL HAZARD DISCLOSURE STATEMENT

NOTE: The seller's listing broker (and the seller) of one-to-four residential units shall prepare a Natural Hazard Disclosure (NHD) and deliver it to prospective buyers prior to making a purchase agreement offer and indicate compliance in the purchase agreement or a counteroffer. If not so disclosed, the buyer has the right to cancel the purchase agreement within three days of delivery of the disclosure in person. [Calif. Civil Code §1103.3]

DATE:_____________, 20______, at____, California.

This disclosure statement is prepared for the following:

☐ Seller's listing agreement

☐ Purchase agreement

☐ Counteroffer

☐ ____

dated ____________, 20______, at ____, California,

entered into by ____, as the ________________________,

regarding real estate referred to as ____

____.

Natural Hazard Disclosure Statement:

Seller and Seller's Agent(s) or a third-party consultant disclose the following information with the knowledge that even though this is not a warranty, prospective buyers may rely on this information in deciding whether and on what terms to purchase the subject property.

Seller hereby authorizes any agent(s) representing any principal(s) in this action to provide a copy of this statement to any person or entity in connection with any actual or anticipated sale of the property.

THE FOLLOWING ARE REPRESENTATIONS MADE BY SELLER AND SELLER'S AGENT(S) BASED ON THEIR KNOWLEDGE AND MAPS DRAWN BY THE STATE AND FEDERAL GOVERNMENT. THIS INFORMATION IS A DISCLOSURE AND IS NOT INTENDED TO BE PART OF ANY CONTRACT BETWEEN BUYER AND SELLER.

THIS REAL PROPERTY LIES WITHIN THE FOLLOWING HAZARDOUS AREA(S): (Check appropriate response)

1. A SPECIAL FLOOD HAZARD AREA (Any type Zone "A" or "V") designated by the Federal Emergency Management Agency.

Yes____ No____ Do not know/information not available from local jurisdiction____

2. AN AREA OF POTENTIAL FLOODING shown on an inundation map pursuant to Section 8589.5 of the Government Code.

Yes____ No____ Do not know/information not available from local jurisdiction____

3. A VERY HIGH FIRE HAZARD SEVERITY ZONE pursuant to Section 51178 or 51179 of the Government Code. The owner of this property is subject to the maintenance requirements of Section 51182 of the Government Code.

Yes____ No____

4. A WILDLAND AREA THAT MAY CONTAIN SUBSTANTIAL FOREST FIRE RISKS AND HAZARDS pursuant to Section 4125 of the Public Resources Code. The owner of this property is subject to the maintenance requirements of Section 4291 of the Public Resources Code. Additionally, it is not the state's responsibility to provide fire protection services to any building or structure located within the wildlands unless the Department of Forestry and Fire Protection has entered into a cooperative agreement with the local agency for those purposes pursuant to Section 4142 of the Public Resources Code.

Yes____ No____

5. AN EARTHQUAKE FAULT ZONE pursuant to Section 2622 of the Public Resources Code.

Yes____ No____

6. A SEISMIC HAZARD ZONE pursuant to Section 2696 of the Public Resources Code.

Yes (Landslide Zone)____ Yes (Liquefaction Zone)____

No____ Map not yet released by state____

THESE HAZARDS MAY LIMIT YOUR ABILITY TO DEVELOP THE REAL PROPERTY, TO OBTAIN INSURANCE OR TO RECEIVE ASSISTANCE AFTER A DISASTER.

THE MAPS ON WHICH THESE DISCLOSURES ARE BASED ESTIMATE WHERE NATURAL HAZARDS EXIST. THEY ARE NOT DEFINITIVE INDICATORS OF WHETHER OR NOT A PROPERTY WILL BE AFFECTED BY A NATURAL DISASTER. BUYER(S) AND SELLER(S) MAY WISH TO OBTAIN PROFESSIONAL ADVICE REGARDING THOSE HAZARDS AND OTHER HAZARDS THAT MAY AFFECT THE PROPERTY.

Check only one of the following:

- ☐ Seller and their agent represent that the information herein is true and correct to the best of their knowledge as of the date signed by Seller and Seller's Agent.
- ☐ Seller and their agent acknowledge that they have exercised good faith in the selection of a third-party report provider as required in Civil Code Section 1103.7, and that the representations made in this Natural Hazard Disclosure Statement are based upon information provided by the independent third-party disclosure provider as a substituted disclosure pursuant to Civil Code Section 1103.4. Neither Seller nor their agent has independently verified the information contained in this statement and report or is personally aware of any errors or inaccuracies in the information contained on the statement. This statement was prepared by

Third-Party Disclosure Provider____ Date ___________

Date:_____________, 20______	Date:_____________, 20______
Seller: ________________________________	Seller's Broker:________________________________
Seller: ________________________________	Agent: ________________________________

Buyer represents that he has read and understands this document. Pursuant to Civil Code Section 1103.8, the representations made in this Natural Hazard Disclosure Statement do not constitute all of Seller's or Seller's Agent's disclosure obligations in this transaction.

Buyer:____ Date: ________________

Buyer:____ Date: ________________

Exhibit "H"

ANNUAL PROPERTY OPERATING DATA SHEET

APOD

DATE: ______________, 20______, at ____, California.

1. **PROPERTY TYPE:** ____

   1.1 Location ____

   1.2 APOD figures are estimates reflecting:

   a. ☐ Current operating conditions.

   b. ☐ Forecast of anticipated operations.

   c. Prepared by ____

2. **INCOME:**

				%
2.1	**Scheduled Rental Income**		$________	100 %
a.	Less: Vacancies, discounts and uncollectibles	– $________		____%
b.	Less: Credit card charges	– $________		____%
2.2	**Effective Rental Income** [Lines 2.1 less 2.1 a and b]		$ 0.00	____%
a.	Other income		+ $________	____%
2.3	**Gross Operating Income**		$ 0.00	____%

3. **EXPENSES:**

3.1	Electricity	$________		____%
3.2	Gas	$________		____%
3.3	Water	$________		____%
3.4	Rubbish	$________		____%
3.5	Insurance	$________		____%
3.6	Taxes	$________		____%
3.7	Management Fee	$________		____%
3.8	Resident Manager	$________		____%
3.9	Office Expenses/Supplies	$________		____%
3.10	Advertising	$________		____%
3.11	Lawn/Gardening	$________		____%
3.12	Pool/Spa	$________		____%
3.13	Janitorial	$________		____%
3.14	Maintenance	$________		____%
3.15	Repairs and Replacements	$________		____%
3.16	CATV/Phone	$________		____%
3.17	Accounting/Legal Fees	$________		____%
3.18	________________	$________		____%
3.19	________________	$________		____%
3.20	**Total Operating Expense** [Lines 3.1 to 3.19]		– $ 0.00	____%

4. **NET OPERATING INCOME:** [Line 2.3 less 3.19] . . . . . $ 0.00 ____%

5. SPENDABLE INCOME (annual projection):

5.1 **Net Operating Income** (enter from section 4). . . . . $ 0.00 ______%

5.2 Loan	Principal Balance Amount	Monthly Payment	Rate	Due Date
a. 1st	$______	$______	______%	______
b. 2nd	$______	$______	______%	______
c. 3rd	$______	$______	______%	______

5.3 Total Annual Debt Service [Lines 5.2 a, b and c] . . . . – $ 0.00 ______%

5.4 **Spendable Income** [Lines 5.1 less 5.3] . . . . $ 0 ______%

6. PROPERTY INFORMATION:

6.1 Price $______; Loan amounts $______; Owner's equity $______.

6.2 Current vacancy rate or vacant space ______%.

6.3 Assessor's allocations for depreciation schedule:
Improvements ______%; Land ______%; Personal property ______%.

6.4 Property disclosures:

a. ☐ Rental Income Rent Roll available; [See **ft** Form 380] ☐ need confidentiality agreement.

b. ☐ Rent control restrictions.

c. ☐ Condition of improvements available: ☐ by owner [See **ft** Form 304-1], ☐ by inspector.

d. ☐ Environmental report available.

e. ☐ Natural Hazard Disclosure Statement available. [See **ft** Form 314]

f. ☐ Soil report available.

g. ☐ Termite report available.

h. ☐ Building specification available.

i. ☐ ______________________

j. ☐ ______________________

7. REPORTABLE INCOME/LOSS (annual projection): For Buyer to fill out.

7.1 **Net Operating Income** (NOI) (enter from section 4) . . . . $ 0.00

7.2 Deductions from NOI

a. Annual interest expense . . . . $______

b. Annual depreciation deduction . . . . $______

c. Total deductions from NOI . . . . – $ 0.00

7.3 **Reportable Income/Loss** (annual projection) . . . . $ 0.00

Broker: ______	**I have reviewed and approve this information.**
Address: ______	Date: ______, 20____
______	
Phone: ______ Cell: ______	Owner's name: ______
Fax: ______	Signature: ______
Email: ______	Signature: ______

Exhibit "I"

RENTAL INCOME RENT ROLL

DATE:_____________, 20______, at ____, California.

Items left blank or unchecked are not applicable.

FACTS:

This is an addendum to the following:

☐ Purchase agreement ☐ Listing agreement for sale or financing

☐ APOD (Annual Property Operating Data) ☐ Counteroffer

☐ Escrow Instructions ☐ __________________________

☐ of same date, or dated_____________, 20______, at __________________________________, California,

entered into by _________________________________ and _______________________________________,

regarding real estate referred to as ____

____.

This rental income rent roll contains ______ page(s).

Unit #	Tenant's Last Name	Rent Amount (monthly)	Date Rent Due	Rental Term	Date Tenancy Expires	Security Deposit	Rental Incentives, Bonuses or Discounts	Delinquent Rent Amount
		$				$		$
		$				$		$
		$				$		$
		$				$		$
		$				$		$
		$				$		$
		$				$		$
		$				$		$
		$				$		$
		$				$		$
		$				$		$
		$				$		$
		$				$		$
		$				$		$
		$				$		$
		$				$		$
		$				$		$
		$				$		$
Totals For This Page:	TOTAL:	$0.00			TOTAL:	$0.00	TOTAL:	$0.00

Date Prepared:_____________, 20______

Prepared By: _________________________________

I certify the above is true and correct.

Owner:____

Owner:____

FORM 352-1 03-08

Exhibit "J"

Area of City/County

(Include a copy of the area map surrounding the property location.)

Exhibit "K"

PROPERTY MANAGEMENT AGREEMENT

DATE: _____________, 20______, at ____, California.

Items left blank and unchecked are not applicable.

1. RETAINER PERIOD:

1.1 Owner hereby retains and grants Broker the exclusive right to lease, rent, operate and maintain the property as Property Manager, commencing _____________, 20______, and continuing for one year and thereafter until terminated.

2. RECEIPT OF SECURITY DEPOSITS:

2.1 Owner hands $_______________ to Broker for deposit into the trust account towards Owner's security deposit obligation to Tenants.

3. RECEIPT OF CASH RESERVE:

3.1 Owner hands $_______________ to Broker as a deposit towards Owner's obligation under the agreement.

3.2 Owner to maintain a minimum cash reserve, in addition to any security deposits, in the amount of $_______________. On request from Broker, Owner will advance additional funds to maintain this minimum balance.

3.3 The cash reserve may be used to pay costs diligently incurred by Broker or due Broker in fulfilling Broker's obligations.

4. BROKERAGE FEE:

NOTICE:The amount or rate of real estate fees is not fixed by law. They are set by each Broker individually and are negotiable between Owner and Broker.

4.1 Broker compensation to be:

a. ______% of all rents collected and deposited by Broker during the month, except for any first month's rent for which a Broker fee is paid under §4.1 b as follows,

b. ______% of the first month's rent collected and deposited under ☐ rental agreements, and ☐ leases,

c. All sums remaining from credit check fees in excess of credit report expenses, and

d. ☐ Late payment charges and returned check charges paid by a tenant.

5. TRUST ACCOUNT:

5.1 Broker will place Owner's deposit for costs and security deposits into
☐ Broker's trust account, or ☐ separate trust account for Owner, maintained with
____________________________________ at their ___________________________________ branch.

a. This account shall be ☐ non-interest bearing, or ☐ interest bearing.

5.2 All funds received by Broker for the account of Owner will be placed in the trust account.

5.3 Amounts to pay and satisfy the obligations incurred by Broker may be disbursed from the account after payment is due.

5.4 On termination of this agreement, Broker will return to Owner all remaining trust funds belonging to Owner.

6. PERIODIC ACCOUNTING:

6.1 Within ten days after each calendar ☐ month, or ☐ quarter, and on termination of this agreement, Broker will deliver to Owner a Statement of Account for all receipts and expenditures, together with a check to Owner for any funds in excess of minimum reserves under §3.2.

6.2 Amounts to compensate Broker under §4 may be withdrawn from the trust account.

6.3 Each Statement of Account delivered by Broker shall include no less than the following information for the period:

a. Amount of security deposits received or refunded.

b. Amount of rent or receipts, itemized by unit.

c. An itemized description of disbursements.

d. End of month balance of the income, expense and security deposit trust accounts.

6.4 ☐ Broker to reserve and disburse from the trust account any property and employee taxes, special assessments, insurance premiums, loan payments and other payments required to be made by the owner.

6.5 Advertising costs incurred to locate new tenants to be paid ☐ by Owner, or ☐ by Broker.

7. TITLE CONDITION AND LOANS:

7.1 The property is referred to as ____
____
____
____.

7.2 Owner's interest in the property is:
☐ Fee simple, ☐ ____

7.3 Loan payments are to be timely disbursed by Broker to:

a. Lender ____
Address ____
____
____
Phone ____
Payment of $_______________, due on the ______ day and delinquent on the ______ day of each month.

b. Lender ____
Address ____
____
____
Phone ____
Payment of $_______________, due on the ______ day and delinquent on the ______ day of each month.

8. BROKER AGREES TO:

8.1 Use diligence in the performance of this employment.

8.2 Continuously maintain a California real estate broker's license.

8.3 Collect all rents, security deposits or other charges and expenses due Owner, and timely refund tenants' security deposits, less allowable deductions and including any interest due tenants.

8.4 Prepare and place advertisements for prospective tenants.

8.5 Show property to prospective tenants, obtain credit reports and confirm creditworthiness of tenants before executing rental or lease agreements.

8.6 Execute, renegotiate or cancel rental or lease agreements with tenants.
No lease to exceed ______ months.

8.7 Serve rent collection and other notices, file unlawful detainer and money damage actions, recover possession of premises or settle with delinquent tenants.

8.8 Inspect the property monthly and each unit when tenants vacate.

8.9 Maintain and periodically confirm the inventory of personal property on premises.

8.10 Evaluate rental and lease agreements periodically for income, expense and provision updates.

8.11 Contract for utilities, services and equipment to operate and maintain the property and safeguard the tenants.

8.12 Contract for any repairs, maintenance or improvements needed to rent or lease the property.
a. Owner to approve all repairs in excess of $_______________.

8.13 Obligate Owner to no unauthorized agreement or liability.

8.14 Protect and enhance the goodwill of Owner's rental business and keep confidential and secure any knowledge of Owner's business activities acquired during this employment.

8.15 Hire, supervise and discharge ☐ a resident manager, and ☐ an assistant resident manager.

8.16 Inspect and take any action necessary to comply with federal, state, county or municipal safety and building codes affecting the property.

8.17 Notify Owner of any potential hazards to the tenants or property, and Owner to respond within seven (7) days. Should an emergency situation arise placing the tenants or property in jeopardy, Broker may immediately remedy the situation without further authority from Owner.

9. OWNER AGREES TO:

9.1 Hand Broker all keys and entry codes to the property, and copies of rental and lease agreements with existing tenants.

9.2 Hand Broker (if Broker is to disburse) loan payment coupons/envelopes, property tax bills, insurance premium billings and _________________________.

9.3 Indemnify Broker for the expense of any legal action arising out of Broker's proper performance of this agreement.

9.4 Provide public liability, property damage and workers' compensation insurance sufficient in amount to protect Broker and Owner, naming Broker as an additional insured.

9.5 Owner's insurance agent is ____
____

10. TERMINATION:

10.1 This agreement shall continue until terminated by mutual written agreement or until either party, for legally justifiable cause, serves a written Notice of Termination.

10.2 Owner may terminate this agreement at any time during the initial one-year term by paying Broker a fee equal to three times Broker's management fee earned during the month preceding termination.

10.3 On termination, Owner will assume the obligation of any contract entered into by Broker under this agreement.

11. GENERAL PROVISIONS:

11.1 Broker is authorized to place a For Rent/Lease sign on the property and publish and disseminate property information.

11.2 Owner authorizes Broker to cooperate with other brokers and divide with them any compensation due.

11.3 The authorized agent-for-service is ☐ Broker, ☐ Owner, ☐ _____________________________________

11.4 Broker may have or will contract to represent Owners of comparable properties or represent Tenants seeking comparable properties during the retainer period. Thus, a conflict of interest exists to the extent Broker's time is required to fulfill the fiduciary duty owed to others he now does or will represent.

11.5 Before any party to this agreement files an action on a dispute arising out of this agreement which remains unresolved after 30 days of informal negotiations, the parties agree to enter into non-binding mediation administered by a neutral dispute resolution organization and undertake a good faith effort during mediation to settle the dispute.

11.6 The prevailing party in any dispute shall be entitled to attorney fees and costs, unless they proceed with litigation without first offering to enter into mediation to resolve the dispute.

11.7 ☐ **See attached addendum(s) for additional terms.** [See **ft** Form 250]

11.8 ____
____

Broker:
I agree to render services on the terms stated above.
☐ See attached Signature Page Addendum. [**ft** Form 251]

Date: ____________, 20_____
Broker's Name: ______________________________
Broker's DRE Identification #: __________________
Agent's Name: ______________________________
Agent's DRE Identification #: __________________
Signature: __________________________________
Address: ___________________________________
____
Phone: ____________________________________
Fax: ______________________________________
Email: ____________________________________

Owner:
I agree to employ Broker on the terms stated above.
☐ See attached Signature Page Addendum. [**ft** Form 251]

Date: ____________, 20_____
Owner: ____________________________________
Signature: __________________________________
Owner: ____________________________________
Signature: _________________________________
Address: ___________________________________
____
Phone: ____________________________________
Fax: ______________________________________
Email: ____________________________________

Exhibit “L”

Property Value Appraisal

(If available, include a copy of the appraiser’s opinion of value from the Appraisal Report.)

LLC-1

File # ______________________

State of California
Secretary of State

LIMITED LIABILITY COMPANY ARTICLES OF ORGANIZATION

A $70.00 filing fee must accompany this form.

IMPORTANT – Read instructions before completing this form.

This Space For Filing Use Only

ENTITY NAME (End the name with the words "Limited Liability Company," or the abbreviations "LLC" or "L.L.C." The words "Limited" and "Company" may be abbreviated to "Ltd." and "Co.," respectively.)

1. NAME OF LIMITED LIABILITY COMPANY

PURPOSE (The following statement is required by statute and should not be altered.)

2. THE PURPOSE OF THE LIMITED LIABILITY COMPANY IS TO ENGAGE IN ANY LAWFUL ACT OR ACTIVITY FOR WHICH A LIMITED LIABILITY COMPANY MAY BE ORGANIZED UNDER THE BEVERLY-KILLEA LIMITED LIABILITY COMPANY ACT.

INITIAL AGENT FOR SERVICE OF PROCESS (If the agent is an individual, the agent must reside in California and both Items 3 and 4 must be completed. If the agent is a corporation, the agent must have on file with the California Secretary of State a certificate pursuant to Corporations Code section 1505 and Item 3 must be completed (leave Item 4 blank).

3. NAME OF INITIAL AGENT FOR SERVICE OF PROCESS

4. IF AN INDIVIDUAL, ADDRESS OF INITIAL AGENT FOR SERVICE OF PROCESS IN CALIFORNIA	CITY	STATE	ZIP CODE
		CA	

MANAGEMENT (Check only one)

5. THE LIMITED LIABILITY COMPANY WILL BE MANAGED BY:

- ☐ ONE MANAGER
- ☐ MORE THAN ONE MANAGER
- ☐ ALL LIMITED LIABILITY COMPANY MEMBER(S)

ADDITIONAL INFORMATION

6. ADDITIONAL INFORMATION SET FORTH ON THE ATTACHED PAGES, IF ANY, IS INCORPORATED HEREIN BY THIS REFERENCE AND MADE A PART OF THIS CERTIFICATE.

EXECUTION

7. I DECLARE I AM THE PERSON WHO EXECUTED THIS INSTRUMENT, WHICH EXECUTION IS MY ACT AND DEED.

______________________ DATE

______________________ SIGNATURE OF ORGANIZER

______________________ TYPE OR PRINT NAME OF ORGANIZER

LLC-1 (REV 04/2007) APPROVED BY SECRETARY OF STATE

Addenda to Articles of Organization (Form LLC-1) of

____, LLC

1.7 No document or instrument purporting to convey an interest in or create lien upon the real estate of the limited liability company shall be of any force or effect without the prior written approval of a majority in interest of the members of the limited liability company.

OPERATING AGREEMENT

for

____, LLC

a California Limited Liability Company

1. FORMATION:

1.1 Date of Agreement: ____, 20______.

1.2 Name of Limited Liability Company: ____, LLC, a California Limited Liability Company.

1.3 Place of Business: The address of the Limited Liability Company is ________________________ ____.

The address may be changed by the Manager by giving at least 10 days' prior written notice to the members.

1.4 Management: Management of the Limited Liability Company shall be vested in a single Manager. The Manager of the Limited Liability Company shall be _________________________.

1.5 Members: See Exhibit "A".

1.6 Applicable Law: The Limited Liability Company is formed under the part of the California Corporations Code known as the Beverly-Killea Limited Liability Company Act.

1.7 No Permits Obtained: The membership interests in the Limited Liability Company have not been registered with any government agency, and no permits have been obtained.

1.8 Articles of Organization: The Manager shall file articles of organization for the Limited Liability Company (Form LLC-1) with the California Secretary of State.

1.9 Purpose: The Limited Liability Company's purpose is to hold title and operate as a long-term investment the real estate described in Exhibit "B".

1.10 Term of the Limited Liability Company: The Limited Liability Company starts on the date of this agreement and will end 30 years from the date unless terminated earlier.

1.11 Limited Liability: No member or Manager shall be liable for any Limited Liability Company losses greater than his capital contribution.

2. CAPITAL CONTRIBUTIONS AND DISTRIBUTIONS OF FUNDS:

2.1 Capital Contributions: The Limited Liability Company's capital shall be:

___________________________________dollars ($_______________) as set forth in Exhibit "A".

2.2 Loans to Limited Liability Company: A member may only lend money to the Limited Liability Company with the Manager's approval. The loan shall be kept in a separate account.

2.3 Definition of "Spendable Income": "Spendable Income" means net receipts remaining from ownership of assets by the Limited Liability Company after deductions for all expenditures on operating expenses, reserves, interest and loan reduction, excluding depreciation schedules.

2.4 Distribution of Spendable Income: Spendable Income is to be distributed first to the Class A members in a sum equal to ______% a year, cumulative, of their original contributions; then to Class B members in a sum equal to ______% a year, cumulative, of their original contributions. Any remaining Spendable Income shall be distributed pro rata to all members based on their ownership interest.

2.5 Participation in Proceeds of Refinance/Sale: Net proceeds from the sale or refinance of all or some of the Limited Liability Company property shall be distributed first to the Class A members, until they have received their capital contributions, plus ______% a year on their original capital contribution since the date of contribution, less any disbursements received; then to Class B members until they have received their capital contributions plus ______% a year on

their original capital contribution since the date of contribution, less any disbursements received. All remaining funds shall be distributed pro rata to all members based on their ownership interest.

2.6 Depreciation Allocation: Should the Limited Liability Company file a Federal Income Tax Form 1065 with the Internal Revenue Service (IRS), depreciation shall be taken on the shortest straight-line method permitted and allocated to the members pro rata based on their ownership interest.

3. MANAGEMENT, COMPENSATION, DUTIES AND POWERS:

3.1 Management of Limited Liability Company Property: The Manager has full charge of the management of the Limited Liability Company property, subject to Section 11.2.

3.2 Compensation: No member or Manager shall be paid for working for the Limited Liability Company or for being a member, except as this section provides.

3.3 Real Estate Fees: The Manager will receive a fee of $_______________ cash for services in the creation and formation of the Limited Liability Company. On a later resale of the property, the Manager is to receive ______% of the price of any resale, and in the event of a refinance, ______% of the refinancing, if he is the procuring cause of the resale or refinance.

3.4 Management Fee: The Manager shall receive a fee for his management of the Limited Liability Company property of ____.

3.5 Duties: The Manager shall do what is needed to conduct the Limited Liability Company business.

3.6 Indemnification: Except for a breach of fiduciary duty to the Limited Liability Company and its members, the Limited Liability Company shall indemnify the Manager and officers against judgments, settlements, penalties, fines or expenses of any kind incurred as a result of acting as an agent of the Limited Liability Company.

3.7 Other Officers (Titles, Duties and Compensation): ____________________________________
____.

4. ACCOUNTS AND ACCOUNTING:

4.1 Inspection of Limited Liability Company Records: The Limited Liability Company shall maintain accurate books at its principal office on the cash method of accounting. All members may inspect such books at reasonable times upon reasonable notice. A separate income and capital account shall be maintained for each member.

4.2 Annual Audit and Report to Members: The Manager shall audit the books and deliver to each member, within 30 days after the end of each calender year, a balance sheet and annual operating statement showing each member's capital account, the distributions to each member, and each member's allocation, by percentage of ownership, of all income, expenses and interest received or paid in the ownership and operation of the property. A majority interest of the members may order an audit of the Limited Liability Company books, at the Limited Liability Company's expense, by an accountant named by a majority of members in ownership.

4.3 Annual Income Tax Returns: If the Limited Liability Company is comprised of 10 or fewer members, husband and wife holding an interest together being one, the company shall file no federal partnership income tax returns (Federal Income Tax Form 1065 and Schedule K-1) and each member shall individually report his pro rata allocation of gross income, operating expenses and interest, and calculate his own depreciation and reportable income or loss from operations.

The Limited Liability Company shall file a Limited Liability Company return (Franchise Tax Board Form 568) annually with the California Franchise Tax Board.

5. **ASSIGNMENT OF INTEREST, SUBSTITUTED MEMBER:**

5.1 Assignment of Interest: A member may assign his membership interest to any other member at any time after he has first given the manager 10 days' notice to buy his interest on the same terms agreed upon with another member.

5.2 Invalid Assignment of Interest: All other assignments or transfers of members' interests are terminated according to the method under Section 6.

6. **TERMINATION OF MEMBERSHIP INTERESTS:**

6.1 Termination of Manager: The termination of the Manager does not terminate any of the Manager's rights as a member.

6.2 Events Causing Termination of a Member: A member may be terminated if any of the following events occur:

a. He dies, unless survived in interest by a joint tenant;

b. He is adjudged insane or incompetent, or is committed to a mental institution;

c. He transfers his interest to a non-member under Section 5.2 without obtaining prior consent from each remaining member;

d. He fails to immediately remove a charging order against his interest;

e. He files for bankruptcy;

f. He voluntarily retires, withdraws or resigns as a member;

g. He is expelled by court order or by all of the remaining members; or

h. He fails to contribute capital to the Limited Liability Company as agreed to in Section 2.1.

6.3 Notice of Termination: Service upon the member to be terminated of a written notice stating the cause for termination and the effective date of termination terminates all of his powers and his right to share in Limited Liability Company profits as of the effective date. The effective date is 30 days after service of the notice. Each remaining member shall be served under Section 13.2 both a copy of the notice of termination and a notice of the option rights held by the remaining members under Section 7.

7. **OPTION TO PURCHASE:**

7.1 Option to Purchase Upon Termination: Upon the termination of a member's interest under Section 6, the remaining members may:

a. Dissolve and liquidate the Limited Liability Company under Section 10.1; or

b. Buy the terminated member's entire interest. Where more than one member exercises his option, those exercising shall purchase their pro rata share based on their aggregate ownership interest.

7.2 Notice of Exercise of Option:

a. When a member dies, notice of the option shall be given to the deceased's representative within 120 days after the representative's appointment.

b. When a member's interest is terminated under Section 6, notice of the exercise of the option shall be given to the terminated member before the effective date of termination, and in the way a notice of termination is given under Section 6.3.

8. **VALUATION OF LIMITED LIABILITY COMPANY INTEREST:**

8.1 Dead, Incompetent or Insane Members: If an election is made to purchase the interest of a member terminated because of death, incompetency or insanity, the value of the interest shall equal:

a. The sum of:

1. The member's capital contributions less distributions; and
2. The balance of the member's income account;

b. Less:
    1. All unpaid assessments due;
    2. All other debts to the Limited Liability Company;
c. Plus the member's interest in the "additional value" of the Limited Liability Company assets, determined as follows:
    1. Each member has a pro rata ownership share of the additional value;
    2. Within 30 days after the close of each calendar year, the members shall execute an "Agreement of Additional Value" (Exhibit "C"). The Agreement shall state an amount set by the members as the increased value of the Limited Liability Company assets over the members' invested capital and purchase and improvement loan balances;
    3. The additional value set within two years before the termination of a deceased, incompetent or insane member binds the remaining members and their successors in interest;
    4. If additional value was not set within two years before the termination of the deceased, incompetent or insane member, it shall be set by arbitration under Section 13.5.

8.2 Other Members: If an election is made to buy the interest of a member who is terminated for reasons other than death, incompetency or insanity, the value of the membership interest shall equal the amount described in Section 8.1, excluding any "additional value."

9. PAYMENT FOR PURCHASE PRICE:

9.1 Dead, Incompetent or Insane Members: Payment of the amount described in Section 8.1 shall be made in ______ equal annual installments including interest of ______% a year. The first installment is due _____________ (______) days after the death, incompetency or insanity of the member. The amount owed shall be evidenced by a promissory note having an alienation-acceleration clause and an attorney fees clause, which shall be executed by all members exercising the option. The note shall be secured by a pledge of the interest purchased.

9.2 Other Members: The amount described in Section 8.2 shall be due and payable upon sale of the Limited Liability Company's property. It shall be evidenced by a non-interest bearing promissory note which shall be executed by all members exercising the option, and shall be secured by a pledge of the interest purchased.

10. DISSOLUTION OF LIMITED LIABILITY COMPANY AND DISTRIBUTION OF CAPITAL:

10.1 Dissolution:

a. The Limited Liability Company shall be dissolved when all the members agree, or upon the death, withdrawal or termination of any member.
b. If the Limited Liability Company is dissolved due to death, withdrawal or termination of a member, the Limited Liability Company may continue by a vote of the remaining members under Section 12 within 90 days of the event causing the dissolution.

10.2 Accounting: Upon dissolution, the Manager shall take account of Limited Liability Company assets and liabilities. The assets shall be sold quickly and for fair value.

10.3 Termination of Business: The Limited Liability Company shall do no further business after dissolution other than that needed to wind up the business and distribute the assets.

10.4 Distribution of Proceeds: Proceeds from the liquidation of Limited Liability Company assets and non-liquidated assets shall be distributed as follows:

a. All Limited Liability Company liabilities shall first be paid;
b. All debts owed to members shall be paid;
c. All remaining funds are to be distributed according to the method described in Section 2.5.

10.5 After Dissolution: The members shall continue to divide assets and liabilities after dissolution according to the method provided in Section 10.4.

11. LIMITATIONS ON MEMBERS' AUTHORITY:

11.1 Manager: Unless all members consent in writing, the Manager may not violate this agreement, make it impossible to perform the Limited Liability Company's business, or confess to judgment against the Limited Liability Company.

11.2 Members: No member may engage in the management or control of the Limited Liability Company business, except as required under a property management contract with the Manager, signed by each member, to produce the necessary control factor over operations of the property for federal income tax rental loss deductions by members reporting individually under Section 4.3.

11.3 Members: No member may withdraw or reduce his contribution to the capital of the Limited Liability Company except as allowed by the buy and sell provisions of this agreement. No member may sue the Limited Liability Company for partition. No member may demand property other than cash or notes in return for his contribution. No member has priority over any other member, except as provided in this agreement for Class A memberships. No member shall have the power or right to cause the termination and dissolution of the Limited Liability Company, except as set forth in this agreement.

11.4 Other Ventures: Any member may have an interest in any other business venture. Neither the Limited Liability Company nor any other member has any right, by this agreement, in any such venture or to its income or profits.

12. VOTING:

12.1 Unanimous Votes: The following matters shall require an unanimous vote of the members of the Limited Liability Company:

a. The assignment of a member's interest to a person who is not a member of the Limited Liability Company; and

b. A decision to continue the Limited Liability Company after the Limited Liability Company is dissolved due to death, withdrawal or termination of any member.

12.2 Majority Vote: In all other matters in which a vote is required, a vote of a majority in interest of the members shall be sufficient.

12.3 Amendments: A majority in interest of the members may vote to amend the articles of organization or the operating agreement of the Limited Liability Company.

12.4 Removal of Manager: A majority in interest of the members may vote to remove the Manager of the Limited Liability Company and substitute a new Manager.

13. MISCELLANEOUS PROVISIONS:

13.1 Validity: If any part of this agreement is invalid, the validity of the remainder of the agreement will not be affected.

13.2 Notice: All notices shall be written and personally delivered or sent by regular mail and registered, or by certified mail, return receipt requested, postage prepaid, to the parties and to the Limited Liability Company at the address stated herein.

13.3 Survival of Rights: This agreement binds the parties and their successors in interest.

13.4 Paragraph Headings: The paragraph headings do not affect the meaning of this agreement.

13.5 Before any party to this agreement files an action on a dispute arising out of this agreement which remains unresolved after 30 days of informal negotiations, the parties agree to enter into non-binding mediation administered by a neutral dispute resolution organization and undertake a good faith effort during mediation to settle the dispute.

13.6 Arbitration: Any dispute between any member and the Limited Liability Company, or regarding any activities of the Manager that cannot be settled by the Manager or by mediation, shall be arbitrated under the rules of the American Arbitration Association.

I AGREE TO THE TERMS OF THIS OPERATING AGREEMENT

Date: _____________, 20______ MANAGER: ____

Exhibit "A"

ADDENDUM TO OPERATING AGREEMENT

for

____, LLC,

a California Limited Liability Company

Members

	Amount of Capital Contribution	Nature of Contribution	Percentage of Interest
MANAGER:			
______________________	-0-	Not Applicable	-0-
______________________	-0-	Not Applicable	-0-
CLASS A MEMBERS:			
______________________	$_______________	________________	_____%
______________________	$_______________	________________	_____%
______________________	$_______________	________________	_____%
______________________	$_______________	________________	_____%
______________________	$_______________	________________	_____%
______________________	$_______________	________________	_____%
______________________	$_______________	________________	_____%
______________________	$_______________	________________	_____%
______________________	$_______________	________________	_____%
______________________	$_______________	________________	_____%
______________________	$_______________	________________	_____%
CLASS B MEMBERS:			
______________________	$_______________	________________	_____%
______________________	$_______________	________________	_____%
______________________	$_______________	________________	_____%
______________________	$_______________	________________	_____%
TOTALS:	**$** 0.00		0 **%**

Exhibit "B"

ADDENDUM TO OPERATING AGREEMENT

for

____, LLC,
a California Limited Liability Company

Legal Description

The real property in the County of ____, State of California, described as follows:

____
____
____
____
____
____
____
____
____
____.

Exhibit "C"

ADDENDUM TO OPERATING AGREEMENT

for

____, LLC,
a California Limited Liability Company

Provisions for Additional Value

The operating agreement contains provisions at Section 8.1(c) for "additional value" and requires, within 30 days after each calendar year, that the parties to the operating agreement agree upon any additional valuation then existing.

It is agreed this _______________ day of _________________, 20______, as follows:

The additional valuation as of this date is $________________. This figure is exclusive of loans, if any, which exist against the interest held by the Limited Liability Company and exclusive of all capital contributions.

This amends the operating agreement to include this additional valuation.

I agree to the terms stated above.

Date: ______________________, 20______ ____
(MEMBER)

Date: ______________________, 20______ ____
(MEMBER)

Date: ______________________, 20______ ____
(MEMBER)

Date: ______________________, 20______ ____
(MEMBER)

Date: ______________________, 20______ ____
(MEMBER)

Date: ______________________, 20______ ____
(MEMBER)

SIGNATURE PAGE FOR OPERATING AGREEMENT

By Manager and Members

I hereby agree to purchase Class A membership interest(s) in ___________________________________ _______________________, a California Limited Liability Company in the sum of $________________. Enclosed herewith is my check for the total sum made payable to _______________________________ _________________________________.

The undersigned hereby executes this page as part of the operating agreement.

METHOD OF TITLE

I desire to hold legal title to my ownership interest in the Limited Liability Company as:

- ☐ Joint Tenants with ____
- ☐ Tenants in Common with ____
- ☐ Separate Property ____
- ☐ Community Property with ____
- ☐ Community Property with Right of Survivorship with _________________
- ☐ Revocable Intervivos Trust, entitled ________________________________

MEMBER

Name: ______________________________ Signature: _______________________________

Address:______________________________

____

Telephone: (_____)____________________

Social Security: _______–_______–_______

ACCEPTED:

______________________________________ ______________________________, 20______.

(Manager) (Date)

SUBSCRIPTION AND AGREEMENT TO INVEST

DATE: ______________, 20______, at ____, California.
From: ____, as the Subscriber/Investor.
To: ____, a California Limited Liability Company.

1. SUBSCRIPTION:

1.1 I hereby offer to invest $___________________ as a Class "A" member of this California Limited Liability Company (LLC).

1.2 Receipt is hereby acknowledged of my deposit in the amount of $_________________ toward the investment.

1.3 I will deliver the balance of the purchase price:
a. ☐ on presentation to me of the signature page of the LLC operating agreement for execution; or
b. ☐ on or before _____________, 20______.

2. GENERAL REPRESENTATIONS:

Check all that apply:

2.1 ☐ I am purchasing the LLC membership interest for my own account, or in a fiduciary capacity for the account and benefit of a person or entity, for long-term investment, and not to resell or distribute to any other person.

2.2 ☐ I understand that the membership interests in this LLC have not been registered with the Securities Exchange Commission, nor qualified as corporate securities with the California Department of Corporations or any other state or federal government agency, and no permits have been obtained.

2.3 ☐ I have studied the investment circular and the LLC operating agreement and I understand the speculative nature of the proposed investment program.

2.4 ☐ I have had unrestricted access to all information concerning the proposed investment and have received no representations or warranties regarding the investment not contained in the investment circular.

2.5 ☐ I have personally carried out a visual inspection of the property being acquired by the LLC.

3. SUITABILITY REPRESENTATIONS:

3.1 My investment in the transaction does not exceed 10% of one or both of the following:
a. ☐ my net worth, exclusive of home, furnishings, and automobiles;
b. ☐ my adjusted gross income for federal income tax purposes for my last tax year or, in the alternative, as estimated for the current year.

3.2 I have known the manager of this LLC personally or in business as follows: ____
____.

3.3 I have had the following investment experience: ____
____
____.

3.4 I have had the following occupational experience: ____
____
____.

3.5 I have attained the following education level: ____
____
____.

☐ See attached Signature Page Addendum. [**ft** Form 251]

INVESTOR'S SIGNATURE: ____ Date: _____________, 20______.
Address: _______________________________ City: _______________________, California, Zip: __________
Phone number: __________________________ Social Security Number: __________________________________.

ACCEPTED BY THE LIMITED LIABILITY COMPANY

MANAGER'S SIGNATURE: _______________________________________ Date: _____________, 20______.